

1997

Software revenue recognition; Statement of position 97-2;

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

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**STATEMENT OF
POSITION 97-2**



AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

October 27, 1997

Software Revenue Recognition

*Issued by the
Accounting Standards Executive Committee*

NOTE

Statements of Position on accounting issues present the conclusions of at least two thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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SUMMARY

This Statement of Position (SOP) provides guidance on applying generally accepted accounting principles in recognizing revenue on software transactions. This SOP supersedes SOP 91-1, *Software Revenue Recognition*. This SOP requires the following:

- If an arrangement to deliver software or a software system does not require significant production, modification, or customization of software, revenue should be recognized when all of the following criteria are met.
 - Persuasive evidence of an arrangement exists.
 - Delivery has occurred.
 - The vendor's fee is fixed or determinable.
 - Collectibility is probable.
- Software arrangements may consist of multiple elements, that is, additional software products, upgrades/enhancements, postcontract customer support (PCS), or services, including elements deliverable only on a when-and-if-available basis. If contract accounting does not apply, the vendor's fee must be allocated to the various elements based on vendor-specific objective evidence of fair values. If sufficient vendor-specific objective evidence of fair values does not exist, all revenue from the arrangement should be deferred until such sufficient evidence exists, or until all elements have been delivered. Exceptions to this guidance are provided for PCS, services that do not involve significant customization, subscriptions, and arrangements in which the fee is based on the number of copies.
- Vendor-specific objective evidence of fair value is limited to (a) the price charged when the element is sold separately, or (b) if the element is not yet being sold separately, the price for each element established by management having the relevant authority.
- The portion of the fee allocated to an element should be recognized as revenue when all of the revenue recognition criteria have been met. In applying those criteria, the delivery of an element is considered not to have occurred if there are undelivered elements that are essential to the functionality of any delivered elements. Additionally, the collectibility of that portion of the fee is not considered

probable if the amount of the fees allocable to delivered elements is subject to forfeiture, refund, or other concession if the undelivered elements are not delivered.

- Separate accounting for a service element of an arrangement is required if both of the following criteria are met.
 - The services are not essential to the functionality of any other element of the transaction.
 - The services are described in the contract such that the total price of the arrangement would be expected to vary as the result of inclusion or exclusion of the services.
- If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the entire arrangement should be accounted for in conformity with Accounting Research Bulletin (ARB) No. 45, *Long-Term Construction-Type Contracts*, using the relevant guidance in SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, unless criteria specified herein for separate accounting for any service element are met.

This SOP is effective for transactions entered into in fiscal years beginning after December 15, 1997. Earlier application is encouraged as of the beginning of fiscal years or interim periods for which financial statements or information have not been issued. Retroactive application of the provisions of this SOP is prohibited.

FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (a) a prospectus for a project to develop a document, (b) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (c) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in their review of proposed projects and proposed documents include the following.

- a. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
- b. The proposal will result in an improvement in practice.
- c. The AICPA demonstrates the need for the proposal.
- d. The benefits of the proposal are expected to exceed the cost of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Software Revenue Recognition

Introduction

1. Statement of Position (SOP) 91-1, *Software Revenue Recognition*, was issued in 1991 to provide guidance on applying generally accepted accounting principles to software transactions and to narrow the range of revenue recognition practices that were in use before its issuance. Since the issuance of SOP 91-1, practice issues have been identified that the AICPA's Accounting Standards Executive Committee (AcSEC) believes are not addressed adequately in SOP 91-1. In addition, AcSEC believes some of the guidance in SOP 91-1 should be reconsidered. This SOP supersedes SOP 91-1.

Scope

2. This SOP provides guidance on when revenue should be recognized and in what amounts for **licensing**, selling, leasing, or otherwise marketing computer software.¹ It should be applied to those activities by all entities that earn such revenue. It does not apply, however, to revenue earned on products or services containing software that is incidental² to the products or services as a whole.
3. In connection with the licensing of an existing product, a vendor might offer a small discount (for example, a coupon or other form of offer for five percent off) on additional licenses of the licensed product or other products that exist

1. Terms defined in the glossary are set in boldface type the first time they appear in this SOP.

2. Indicators of whether software is incidental to a product as a whole include (but are not limited to) (a) whether the software is a significant focus of the marketing effort or is sold separately, (b) whether the vendor is providing postcontract customer support, and (c) whether the vendor incurs significant costs that are within the scope of FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*. An example of the applicability of this SOP to revenue earned on products containing software is included in appendix A, "Examples of the Application of Certain Provisions of This Statement of Position."

at the time of the offer but are not part of the arrangement. Such marketing and promotional activities are not unique to software and are not included in the scope of this SOP.³

Relationship to Other Pronouncements

4. If a lease of software includes property, plant, or equipment, the revenue attributable to the property, plant, or equipment should be accounted for in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 13, *Accounting for Leases*, and any revenue attributable to the software, including **post-contract customer support (PCS)**, should be accounted for separately in conformity with the guidance set forth in this SOP. However, in conformity with paragraph 2, if the property, plant, or equipment contains software that is incidental to the property, plant, or equipment as a whole, the software should not be accounted for separately.
5. A number of the requirements of this SOP are similar to or overlap those in certain pronouncements of the Accounting Principles Board (APB) or the FASB, such as FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*. This SOP does not alter the requirements of any APB Opinion or FASB pronouncement.

Conclusions

6. The following conclusions should be read in conjunction with the “Basis for Conclusions” section, beginning with paragraph 93 of this SOP, and the examples in appendix A, “Examples of the Application of Certain Provisions of This Statement of Position.”

Basic Principles

7. Software arrangements range from those that provide a license for a single software product to those that, in addi-

3. As discussed in paragraph 9, arrangements may include multiple elements. If the discount or other concessions in an arrangement are more than insignificant, a presumption is created that an additional element(s) (as defined in paragraph 9) is being offered in the arrangement.

tion to the **delivery** of software or a software system, require significant production, modification, or customization of software. If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the entire arrangement should be accounted for in conformity with Accounting Research Bulletin (ARB) No. 45, *Long-Term Construction-Type Contracts*, using the relevant guidance herein, and in SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*.⁴

8. If the arrangement does not require significant production, modification, or customization of software, revenue should be recognized when all of the following criteria are met.
 - Persuasive evidence of an arrangement exists.
 - Delivery has occurred.
 - The vendor's fee is fixed or determinable.
 - Collectibility is probable.⁵
9. Software arrangements may provide licenses for multiple software deliverables (for example, software products, **upgrades/enhancements**, PCS, or services), which are termed multiple *elements*. A number of the elements may be described in the arrangement as being deliverable only on a **when-and-if-available** basis. When-and-if-available deliverables should be considered in determining whether an arrangement includes multiple elements. Accordingly, the requirements of this SOP with respect to arrangements that consist of multiple elements should be applied to all additional products and services specified in the arrangement, including those described as being deliverable only on a when-and-if-available basis.
10. If an arrangement includes multiple elements, the fee should be allocated to the various elements based on vendor-specific objective evidence of fair value, regardless of

4. If a software arrangement includes services that meet the criteria discussed in paragraph 65 of this SOP, those services should be accounted for separately.

5. The term *probable* is used in this SOP with the same definition as used in FASB Statement No. 5, *Accounting for Contingencies*.

any separate prices stated within the contract for each element. Vendor-specific objective evidence of fair value is limited to the following:

- The price charged when the same element is sold separately
- For an element not yet being sold separately, the price established by management having the relevant authority; it must be probable that the price, once established, will not change before the separate introduction of the element into the marketplace

The amount allocated to undelivered elements is not subject to later adjustment.⁶ However, if it becomes probable that the amount allocated to an undelivered element will result in a loss on that element of the arrangement, the loss should be recognized pursuant to FASB Statement No. 5, *Accounting for Contingencies*. When a vendor's pricing is based on multiple factors such as the number of products and the number of users, the amount allocated to the same element when sold separately must consider all the factors of the vendor's pricing structure.

- 11.** If a discount is offered in a multiple-element arrangement, a proportionate amount of that discount should be applied to each element included in the arrangement based on each element's fair value without regard to the discount. However, as discussed in paragraph 37, no portion of the discount should be allocated to any upgrade rights.
- 12.** If sufficient vendor-specific objective evidence does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement should be deferred until the earlier of the point at which (a) such sufficient vendor-specific objective evidence does exist or (b) all elements of the arrangement have been delivered. The following exceptions to this guidance are provided.
 - If the only undelivered element is PCS, the entire fee should be recognized ratably (see paragraphs 56 through 62).

6. This does not apply to changes in the estimated percentage of customers not expected to exercise an upgrade right. See paragraph 37.

- If the only undelivered element is services that do not involve significant production, modification, or customization of software (for example, training or installation), the entire fee should be recognized over the period during which the services are expected to be performed (see paragraphs 63 through 71).
 - If the arrangement is in substance a subscription, the entire fee should be recognized ratably (see paragraphs 48 and 49).
 - If the fee is based on the number of copies, the arrangement should be accounted for in conformity with paragraphs 43 through 47.
- 13.** The portion of the fee allocated to an element should be recognized as revenue when the criteria in paragraph 8 of this SOP are met with respect to the element. In applying those criteria, the delivery of an element is considered not to have occurred if there are undelivered elements that are essential to the functionality of the delivered element, because the **customer** would not have the full use of the delivered element.
- 14.** No portion of the fee (including amounts otherwise allocated to delivered elements) meets the criterion of collectibility if the portion of the fee allocable to delivered elements is subject to forfeiture, refund, or other concession if any of the undelivered elements are not delivered. In order for the revenue related to an arrangement to be considered not subject to forfeiture, refund, or other concession, management must intend not to provide refunds or concessions that are not required under the provisions of the arrangement. All available evidence should be considered to determine whether the evidence persuasively indicates that the revenue is not subject to forfeiture, refund, or other concession. Although no single item of evidence may be persuasive, the following additional items should be considered:
- Acknowledgment in the arrangement of products not currently available or not to be delivered currently
 - Separate prices stipulated in the arrangement for each deliverable element

- Default and damage provisions as defined in the arrangement
- Enforceable payment obligations and due dates for the delivered elements that are not dependent on the delivery of the future deliverable elements, coupled with the intent of the vendor to enforce rights of payment
- Installation and use of the delivered software
- Support services, such as telephone support, related to the delivered software being provided currently by the vendor

Regardless of the preceding, the vendor's historical pattern of making refunds or other concessions that were not required under the original provisions (contractual or other) of other arrangements should be considered more persuasive than terms included in the arrangement that indicate that no concessions are required.

Evidence of an Arrangement

- 15.** Practice varies with respect to the use of written contracts. Although a number of sectors of the industry rely upon signed contracts to document arrangements, other sectors of the industry that license software (notably the packaged software sector) do not.
- 16.** If the vendor operates in a manner that does not rely on signed contracts to document the elements and obligations of an arrangement, the vendor should have other forms of evidence to document the transaction (for example, a purchase order from a third party or on-line authorization). If the vendor has a customary business practice of utilizing written contracts, evidence of the arrangement is provided only by a contract signed by both parties.
- 17.** Even if all other requirements set forth in this SOP for the recognition of revenue are met (including delivery), revenue should not be recognized on any element of the arrangement unless persuasive evidence of an arrangement exists.

Delivery

- 18.** The second criterion in paragraph 8 for revenue recognition is delivery. The principle of not recognizing revenue before delivery applies whether the customer is a **user** or a **reseller**. Except for arrangements in which the fee is a function of the number of copies, delivery is considered to have occurred upon the transfer of the product master or, if the product master is not to be delivered, upon the transfer of the first copy. For software that is delivered electronically, the delivery criterion of paragraph 8 is considered to have been met when the customer either (a) takes possession of the software via a download (that is, when the customer takes possession of the electronic data on its hardware), or (b) has been provided with access codes that allow the customer to take immediate possession of the software on its hardware pursuant to an agreement or purchase order for the software. In such cases, revenue should be recognized if the other criteria of paragraph 8 have been satisfied.
- 19.** Paragraphs 20 to 25 provide guidance on determining whether delivery is considered to have occurred in certain kinds of software transactions.

Customer Acceptance

- 20.** After delivery, if uncertainty exists about customer acceptance of the software, license revenue should not be recognized until acceptance occurs.

Determining Delivery—Multiple Copies of Software Products Versus Multiple Licenses

- 21.** Arrangements to use multiple copies of a software product under **site licenses** with users and to market multiple copies of a software product under similar arrangements with resellers should be distinguished from arrangements to use or market multiple single licenses of the same software.
- In the former kind of arrangement, duplication is incidental to the arrangement, and the delivery criterion is met upon the delivery of the first copy or product master. The vendor may be obligated to furnish up to a specified number of copies of the software,

but only if the copies are requested by the user. The licensing fee is payable even if no additional copies are requested by the user or reseller. If the other criteria in this SOP for revenue recognition are met, revenue should be recognized upon delivery of the first copy or product master. The estimated costs of duplication should be accrued at that time.

- In the latter kind of arrangement, the licensing fee is a function of the number of copies delivered to, made by, or deployed by the user or reseller. Delivery occurs and revenue should be recognized as the copies are made by the user or sold by the reseller if the other criteria in this SOP for revenue recognition are met.

Delivery Other Than to the Customer

- 22.** Delivery should not be considered complete unless the destination to which the software is shipped is the customer's place of business or another site specified by the customer. In addition, if a customer specifies an intermediate site but a substantial portion of the fee is not payable until the delivery by the vendor to another site specified by the customer, revenue should not be recognized until the delivery is made to that other site.

Delivery Agents

- 23.** Vendors may engage agents, often referred to as fulfillment houses, to either duplicate and deliver or only deliver software products to customers. Revenue from transactions involving delivery agents should be recognized when the software is delivered to the customer. Transferring the fulfillment obligation to an agent of the vendor does not relieve the vendor of the responsibility for delivery. This is the case even if the vendor has no direct involvement in the actual delivery of the software product to the customer.

Authorization Codes

- 24.** In a number of software arrangements, vendors use **authorization codes**, commonly referred to as *keys*, to permit

customer access to software that otherwise would be restricted. Keys are used in a variety of ways and may serve different purposes. For example, permanent keys may be used to control access to the software, or additional permanent keys may be necessary for the duplication of the software. Temporary keys may be used for the same purposes and also may be used to enhance the vendor's ability to collect payment or to control the use of software for demonstration purposes.

25. In software arrangements involving the use of keys, delivery of a key is not necessarily required to satisfy the vendor's delivery responsibility. The software vendor should recognize revenue on delivery of the software if all other requirements for revenue recognition under this SOP and all of the following conditions are met.

- The customer has licensed the software, and the vendor has delivered a version of the software that is fully functional except for the permanent key or the additional keys (if additional keys are used to control the reproduction of the software).
- The customer's obligation to pay for the software and the terms of payment, including the timing of payment, are not contingent on delivery of the permanent key or additional keys (if additional keys are used to control the reproduction of the software).
- The vendor will enforce and does not have a history of failing to enforce its right to collect payment under the terms of the original arrangement.

In addition, if a temporary key is used to enhance the vendor's ability to collect payment, the delivery of additional keys, whether temporary or permanent, is not required to satisfy the vendor's delivery responsibility if (a) the above conditions are met and (b) the use of a temporary key in such circumstances is a customary practice of the vendor. Selective issuance of temporary keys might indicate that collectibility is not probable or that the software is being used only for demonstration purposes.

Fixed or Determinable Fees and Collectibility

- 26.** The other prerequisites in paragraph 8 for revenue recognition are that (a) the vendor's fee is fixed or determinable and (b) collectibility is probable. A software licensing fee is not fixed or determinable if the amount is based on the number of units distributed or copied, or the expected number of users of the product. Revenue recognition for variable-pricing arrangements is discussed in paragraphs 43 to 47 of this SOP. Additionally, if an arrangement includes (a) rights of return or (b) rights to refunds without return of the software, FASB Statement No. 48 requires that conditions that must be met in order for the vendor to recognize revenue include that the amount of future returns or refunds can be reasonably estimated.

Factors That Affect the Determination of Whether a Fee is Fixed or Determinable and Collectible

- 27.** A number of arrangements that call for fixed or determinable payments, including minimum royalties or license fees from resellers, specify a payment period that is short in relation to the period during which the customer is expected to use or market the related products. Other arrangements have payment terms that extend over a substantial portion of the period during which the customer is expected to use or market the related products. Because a product's continuing value may be reduced due to the subsequent introduction of enhanced products by the vendor or its competitors, the possibility that the vendor still may provide a refund or concession to a creditworthy customer to liquidate outstanding amounts due under the original terms of the arrangement increases as payment terms become longer.
- 28.** For the reason cited in paragraph 27, *any* extended payment terms in a software licensing arrangement may indicate that the fee is not fixed or determinable. Further, if payment of a significant portion of the software licensing fee is not due until after expiration of the license or more than twelve months after delivery, the licensing fee should be *presumed* not to be fixed or determinable. However, this presumption may be overcome by evidence that the

vendor has a standard business practice of using long-term or installment contracts and a history of successfully collecting under the original payment terms without making concessions. In such a situation, a vendor should consider such fees fixed or determinable and should recognize revenue upon delivery of the software, provided all other conditions for revenue recognition in this SOP have been satisfied.

- 29.** If it cannot be concluded that a fee is fixed or determinable at the outset of an arrangement, revenue should be recognized as payments from customers become due (assuming all other conditions for revenue recognition in this SOP have been satisfied).
- 30.** For reseller arrangements, the following factors also should be considered in evaluating whether the fixed or determinable fee and collectibility criteria for revenue recognition are met.
- Business practices, the reseller's operating history, competitive pressures, informal communications, or other factors indicate that payment is substantially contingent on the reseller's success in distributing individual units of the product.⁷
 - Resellers are new, undercapitalized, or in financial difficulty and may not demonstrate an ability to honor a commitment to make fixed or determinable payments until they collect cash from their customers.
 - Uncertainties about the potential number of copies to be sold by the reseller may indicate that the amount of future returns cannot be reasonably estimated on delivery; examples of such factors include the newness of the product or marketing channel, competitive products, or dependence on the market potential of another product offered (or anticipated to be offered) by the reseller.
 - Distribution arrangements with resellers require the vendor to rebate or credit a portion of the original fee if the vendor subsequently reduces its price for a

7. Contractual arrangements under which the reseller is obligated to pay only as and if sales are made to users should be accounted for as consignments.

product and the reseller still has rights with respect to that product (sometimes referred to as price protection). If a vendor is unable to reasonably estimate future price changes in light of competitive conditions, or if significant uncertainties exist about the vendor's ability to maintain its price, the arrangement fee is not fixed or determinable. In such circumstances, revenue from the arrangement should be deferred until the vendor is able to reasonably estimate the effects of future price changes and the other conditions of this SOP have been satisfied.

- 31. *Customer Cancellation Privileges.*** Fees from licenses cancelable by customers are neither fixed nor determinable until the cancellation privileges lapse. Fees from licenses with cancellation privileges expiring ratably over the license period are considered to become determinable ratably over the license period as the cancellation privileges lapse. In applying the provisions of this paragraph, obligations related to warranties for defective software, including warranties that are routine, short-term, and relatively minor, should be accounted for in conformity with FASB Statement No. 5. Additionally, short-term rights of return, such as thirty-day money-back guarantees, should not be considered cancellation privileges; the related returns should be accounted for in conformity with FASB Statement No. 48.
- 32. *Fiscal Funding Clauses.*** Fiscal funding clauses sometimes are found in software license arrangements in which the licensees are governmental units. Such clauses generally provide that the license is cancelable if the legislature or funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the licensing arrangement.
- 33.** Consistent with FASB Technical Bulletin No. 79-10, *Fiscal Funding Clauses in Lease Agreements*, a software licensing arrangement with a governmental unit containing a fiscal funding clause should be evaluated to determine whether the uncertainty of a possible license arrangement

cancellation is a remote contingency.⁸ If the likelihood is assessed as remote, the software licensing arrangement should be considered noncancelable. Such an assessment should include the factors discussed in paragraphs 27 and 28 of this SOP. If the likelihood is assessed as other than remote, the license should be considered cancelable, thus precluding revenue recognition. A fiscal funding clause with a customer other than a governmental unit that is required to include such a clause creates a contingency that precludes revenue recognition until the requirements of the clause and all other provisions of this SOP have been satisfied.

Multiple-Element Arrangements

- 34.** As discussed in paragraph 9, multiple-element arrangements to which contract accounting does not apply may include customer rights to any combination of additional software deliverables, services, or PCS. If contract accounting does not apply, individual elements in such arrangements should be accounted for in accordance with paragraphs 8 to 14. Paragraphs 35 to 73 provide guidance on the application of those paragraphs to multiple-element arrangements.

Additional Software Deliverables and Rights to Exchange or Return Software

- 35.** As part of a multiple-element arrangement, a vendor may agree to deliver software currently and to deliver additional software in the future. The additional deliverables may include upgrades/enhancements or additional software products. Additionally, a vendor may provide the customer with the right to exchange or return software, including the right to transfer software from one hardware **platform** or operating system to one or more other platforms or operating systems (a **platform-transfer right**).
- 36. Upgrades/Enhancements.** As part of a multiple-element arrangement, a vendor may agree to deliver software currently and provide the customer with an **upgrade right** for

8. The evaluation of whether the level of uncertainty of possible cancellation is remote should be consistent with FASB Statement No. 5, which defines *remote* as relating to conditions in which “the chance of the future event or events occurring is slight.”

a specified upgrade/enhancement. The upgrade right may be evidenced by a specific agreement, commitment, or the vendor's established practice. (Rights to receive *unspecified* upgrades/enhancements on a when-and-if-available basis are PCS, as it has been redefined in this SOP.) The upgrade right should be accounted for as a separate element in accordance with paragraphs 8 through 14. Guidance on the application of those paragraphs to multiple-element software arrangements that include upgrade rights is given in paragraphs 37 and 38.

- 37.** If a multiple-element arrangement includes an upgrade right, the fee should be allocated between the elements based on vendor-specific objective evidence of fair value. The fee allocated to the upgrade right is the price for the upgrade/enhancement that would be charged to existing users of the software product being updated. If the upgrade right is included in a multiple-element arrangement on which a discount has been offered (see paragraph 11), no portion of the discount should be allocated to the upgrade right. If sufficient vendor-specific evidence exists to reasonably estimate the percentage of customers that are not expected to exercise the upgrade right, the fee allocated to the upgrade right should be reduced to reflect that percentage. This estimated percentage should be reviewed periodically. The effect of any change in that percentage should be accounted for as a change in accounting estimate.
- 38.** The amount of the fee allocated to the upgrade right should be recognized as revenue when the conditions in paragraphs 8 through 14 are met. If sufficient vendor-specific objective evidence does not exist for the allocation of the fee to the upgrade right, revenue from the arrangement should be deferred until the earlier of the point at which (a) such sufficient vendor-specific objective evidence does exist or (b) all elements of the arrangement have been delivered.
- 39.** *Additional Software Products.* As part of a multiple-element arrangement, a vendor may agree to deliver software currently and deliver specified additional software products in the future. The rights to these additional products may be included either in the terms of a PCS arrangement

or in a separate agreement. Even if the rights to the additional software products are included in a PCS arrangement, the revenue allocable to the additional software products should be accounted for separately from the PCS arrangement as an element of a multiple-element arrangement.

- 40.** Multiple-element arrangements that include rights to undelivered additional software products that are not subscriptions (see paragraphs 48 and 49) should be accounted for in accordance with paragraphs 8 through 14 of this SOP. Guidance on the application of those paragraphs to such arrangements is provided in paragraphs 41 through 47 below.
- 41.** The fee from the arrangement should be allocated among the products based on vendor-specific objective evidence of fair value. The allocation should be based on the relative sales prices (determined pursuant to paragraphs 10 and 11 of this SOP) of the products. If vendor-specific objective evidence of fair value does not exist, paragraph 12 of this SOP requires that all revenue from the arrangement be deferred until the earlier of the point at which (a) such sufficient vendor-specific objective evidence does exist or (b) all elements of the arrangement have been delivered. The fee allocated to the additional software products should not be reduced by the percentage of any customers that are not expected to exercise the right to receive additional software products.
- 42.** If the arrangement is based on a price per product (not a price per copy), the portion of the fee allocated to a product should be recognized as revenue when the product is delivered, assuming all other provisions of paragraphs 8 through 14 of this SOP are met.
- 43.** Some fixed fee license or reseller arrangements provide customers with the right to reproduce or obtain copies at a specified price per copy (rather than per product) of two or more software products up to the total amount of the fixed fee. A number of the products covered by the arrangement may not be deliverable or specified at the inception of the arrangement. Although the price per copy is fixed at the inception of the arrangement, an allocation of the arrangement fee to the individual products generally cannot be

made, because the total revenue allocable to each software product is unknown and depends on the choices to be made by the customer and, sometimes, future development activity while the arrangement is in effect. Nevertheless, as discussed in paragraph 46 of this SOP, in certain situations, revenue can be allocated to the products that are undeliverable or not specified at the inception of the arrangement.

- 44.** In arrangements in which no allocation can be made, until the first copy or product master of each product covered by the arrangement has been delivered to the customer assuming the provisions of paragraphs 8 to 14 of this SOP are met, revenue should be recognized as copies of delivered products either (a) are reproduced by the customer or (b) are furnished to the customer if the vendor is duplicating the software. Once the vendor has delivered the product master or the first copy of all products covered by the arrangement, any licensing fees not previously recognized should be recognized. (At that point, only duplication of the software is required to satisfy the vendor's delivery requirement. As discussed in paragraph 21 of this SOP, duplication of the software is incidental to the arrangement, and delivery is deemed to have occurred upon delivery of the product master or first copy.) When the arrangement terminates, the vendor should recognize any licensing fees not previously recognized.
- 45.** The revenue from the kind of arrangements discussed in paragraph 44 should not be recognized fully until at least one of the following conditions is met.
- Delivery is complete for all products covered by the arrangement.
 - The aggregate revenue attributable to all copies of the software products delivered is equal to the fixed fee, provided that the vendor is not obligated to deliver additional software products under the arrangement.
- 46.** Nevertheless, certain arrangements that include products that are not deliverable at the inception impose a maximum number of copies of the undeliverable product(s) to which the customer is entitled. In such arrangements, a portion of the arrangement fee should be allocated to the

undeliverable product(s). This allocation should be made assuming that the customer will elect to receive the maximum number of copies of the undeliverable product(s).

- 47.** The revenue allocated to the delivered products should be recognized when the product master or first copy is delivered. If, during the term of the arrangement, the customer reproduces or receives enough copies of these delivered products so that revenue allocable to the delivered products exceeds the revenue previously recognized, such additional revenue should be recognized as the copies are reproduced or delivered. The revenue allocated to the undeliverable product(s) should be reduced by a corresponding amount.
- 48.** As part of a multiple-element arrangement with a user, a vendor may agree to deliver software currently and to deliver *unspecified* additional software products in the future (including unspecified platform transfer rights that do not qualify for exchange accounting as described in paragraphs 50 to 55). For example, the vendor may agree to deliver all new products to be introduced in a family of products over the next two years. These arrangements are similar to arrangements that include PCS in that future deliverables are unspecified. Nevertheless, they are distinguished from arrangements that include PCS because the future deliverables are products, not unspecified upgrades/enhancements.
- 49.** The software elements of the kinds of arrangements discussed in paragraph 48 should be accounted for as subscriptions. No allocation of revenue should be made among any of the software products, and all software product-related revenue from the arrangement should be recognized ratably over the term of the arrangement beginning with delivery of the first product. If the term of the arrangement is not stated, the revenue should be recognized ratably over the estimated economic life of the products covered by the arrangement, beginning with delivery of the first product. An intent on the part of the vendor not to develop new products during the term of the arrangement does not relieve the vendor of the requirement to recognize revenue ratably over the term of the arrangement, beginning with the delivery of the first product.

- 50. *Rights to Exchange or Return Software.*** As part of an arrangement, a software vendor may provide the customer with the right to return software or to exchange software for products with no more than minimal differences in price, functionality, or features. The accounting for returns is significantly different from the accounting for exchanges. Although it is sometimes difficult to determine whether a transaction is a return or exchange of software, the fact that the software is not returned physically does not preclude accounting for the transaction as either an exchange or as a return. If the software is not returned physically and the customer contractually is entitled to continue to use the previously delivered software, the arrangement should be accounted for in the manner prescribed in the section herein entitled “Additional Software Products” (see paragraphs 39 to 49). If the software is not returned physically and the customer contractually is not entitled to continue to use the previously delivered software, the transaction should be accounted for either as a return or as an exchange, as discussed in the following paragraphs.
- 51.** If the rights discussed in the previous paragraph are offered to users (but not resellers), the exchanges are analogous to “exchanges by ultimate customers of one item for another of the same kind, quality, and price... [that] are not considered returns” described in footnote 3 of FASB Statement No. 48. Conversely, exchanges by users of software products for dissimilar software products or for similar software products with more than minimal differences in price, functionality, or features are considered returns, and revenue related to arrangements that provide users with the rights to make such exchanges should be accounted for in conformity with FASB Statement No. 48. If the other product(s) is not available at the time the initial product is delivered, there should be persuasive evidence that demonstrates there will be no more than minimal differences in price, features, or functionality among the products in order for the right to qualify as a right to exchange. Additionally, if the vendor expects to incur a significant amount of development costs related to the other product, the other product should be considered to have more than a minimal difference in functionality.

- 52.** As part of a multiple-element arrangement, a vendor may grant a user a platform-transfer right. Depending on the circumstances, the exercise of a platform-transfer right may represent an exchange, a return, or additional software products for accounting purposes. If the customer contractually is entitled to continue to use the software that was delivered originally (in addition to the software that is to be delivered for the new platform), the platform transfer right should be accounted for in the manner prescribed in the section herein entitled “Additional Software Products” (see paragraphs 39 to 49).
- 53.** If, as part of a multiple-element arrangement, a vendor offers a user (not a reseller) a platform-transfer right, and the provisions of paragraphs 8 to 14 of this SOP are met, the revenue from the software license should be recognized upon the initial delivery of the software, and the exercise of the platform-transfer right should be treated as an exchange, if the platform-transfer right—
- Is for the same product (see paragraph 54).
 - Does not increase the number of copies or concurrent users of the software product available under the license arrangement.
- 54.** Products are considered to be the same product if there are no more than minimal differences among them in price, features, and functions, and if they are marketed as the same product, even though there may be differences arising from environmental variables such as operating systems, databases, user interfaces, and platform scales. Indicators of “marketed as the same product” include (a) the same product name (although version numbers may differ) and (b) a focus on the same features and functions.
- 55.** As part of their standard sales terms or as a matter of practice, vendors may grant resellers the rights to exchange unsold software for other software (including software that runs on a different hardware platform or operating system). Because the reseller is not the ultimate customer (see paragraph 51), such exchanges, including those referred to as stock balancing arrangements, should be accounted for as returns. Arrangements that grant rights to

make such exchanges should be accounted for in conformity with FASB Statement No. 48, even if the vendors require the resellers to purchase additional software to exercise the exchange rights.

Postcontract Customer Support

- 56.** Software arrangements may include the right to PCS. PCS includes the right to receive PCS services or *unspecified* upgrades/enhancements, or both, offered to users or resellers. A vendor may develop historical patterns of regularly providing all customers or certain kinds of customers with the services or unspecified upgrades/enhancements normally associated with PCS, or may anticipate doing so, even though there is no written contractual obligation or the stipulated PCS term commences at some date after delivery. In those situations, an implied PCS arrangement exists that commences upon product delivery. For purposes of applying the guidance in this SOP, PCS includes a vendor's expected performance based on such patterns, even if performance is entirely at the vendor's discretion and not pursuant to a formal agreement.
- 57.** If a multiple-element software arrangement includes explicit or implicit rights to PCS, the total fees from the arrangement should be allocated among the elements based on vendor-specific objective evidence of fair value, in conformity with paragraph 10. The fair value of the PCS should be determined by reference to the price the customer will be required to pay when it is sold separately (that is, the renewal rate). The portion of the fee allocated to PCS should be recognized as revenue ratably over the term of the PCS arrangement, because the PCS services are assumed to be provided ratably. However, revenue should be recognized over the period of the PCS arrangement in proportion to the amounts expected to be charged to expense for the PCS services rendered during the period if—
- Sufficient vendor-specific historical evidence exists demonstrating that costs to provide PCS are incurred on other than a straight-line basis. In making this determination, the vendor should take into consideration allocated portions of cost accounted for as

research and development (R&D) costs and the amortization of costs related to the upgrade-enhancement capitalized in conformity with FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*. Such costs should be considered as part of the costs to provide PCS.

- The vendor believes that it is probable that the costs incurred in performing under the current arrangement will follow a similar pattern.

Because the timing, frequency, and significance of unspecified upgrades/enhancements can vary considerably, the point at which unspecified upgrades/enhancements are expected to be delivered should not be used to support income recognition on other than a straight-line basis.

- 58.** If sufficient vendor-specific objective evidence does not exist to allocate the fee to the separate elements and the only undelivered element is PCS, the entire arrangement fee should be recognized ratably over (a) the contractual PCS period (for those arrangements with explicit rights to PCS) or (b) the period during which PCS is expected to be provided (for those arrangements with implicit rights to PCS).
- 59.** PCS revenue may be recognized together with the initial licensing fee on delivery of the software if all of the following conditions are met.
- a.** The PCS fee is included with the initial licensing fee.
 - b.** The PCS included with the initial license is for one year or less.
 - c.** The estimated cost of providing PCS during the arrangement is insignificant.
 - d.** Unspecified upgrades/enhancements offered during PCS arrangements historically have been and are expected to continue to be minimal and infrequent.

If PCS revenue is recognized upon the delivery of the software, the vendor must accrue all estimated costs of providing the services, including upgrades/enhancements. Upgrades/enhancements are not developed solely for distri-

bution to PCS customers; revenues are expected to be earned from providing the enhancements to other customers as well. Therefore, costs should be allocated between PCS arrangements and other licenses.

60. A determination that unspecified upgrades/enhancements offered during the PCS arrangement are expected to be minimal and infrequent should be evidenced by the patterns of minimal and infrequent unspecified upgrades/enhancements offered in previous PCS arrangements. A conclusion that unspecified upgrades/enhancements are expected to be minimal and infrequent should not be reached simply because unspecified upgrades/enhancements have been or are expected to be offered less frequently than on an annual basis. Regardless of the vendor's history of offering unspecified upgrades/enhancements to initial licensees, PCS should be accounted for separately from the initial licensing fee if the vendor expects to offer upgrades/enhancements that are greater than minimal or more than infrequent to the users or resellers of the licensed software during the PCS arrangement.

61. *Postdelivery Telephone Support at No Additional Charge.* Postdelivery telephone support provided to users by the vendor at no additional charge should be accounted for as PCS, in conformity with this SOP, regardless of whether the support is provided explicitly under the licensing arrangement. Although such telephone support may be offered or available for periods exceeding one year, if the vendor has established a history of providing substantially all the telephone support within one year of the licensing or sale of the software, the PCS may be considered to have a term of one year or less in applying paragraph 59, item (b) of this SOP. Accordingly, revenue allocable to telephone support may be recognized together with the initial licensing fee on delivery of the software if all the conditions in paragraph 59 of this SOP are met. This provision applies only to telephone support provided at no additional charge. If revenue allocable to telephone support is recognized together with the licensing fee on delivery, the vendor should accrue the estimated cost of providing that support.

- 62. *PCS Granted by Resellers.*** An arrangement in which a vendor grants a reseller the right to provide unspecified upgrades/enhancements to the reseller's customers is an implied PCS arrangement between the vendor and the reseller, even if the vendor does not provide direct telephone support to the reseller's customers. If sufficient vendor-specific objective evidence does not exist to allocate the fee to the software and the PCS, revenue from both the licensing arrangement and the PCS should be recognized ratably over the period during which PCS is expected to be provided.

Services

- 63.** Certain arrangements include both software and service elements (other than PCS-related services). The services may include training, installation, or consulting. Consulting services often include implementation support, software design or development, or the customization or modification of the licensed software.
- 64.** If an arrangement includes such services, a determination must be made as to whether the service element can be accounted for separately as the services are performed. Paragraph 65 discusses the criteria that must be considered in making such a determination. If the nature of the services is such that the service element does not qualify for separate accounting as a service, contract accounting must be applied to both the software and service elements included in the arrangement. Paragraphs 74 to 91 of this SOP address the application of contract accounting to software arrangements.
- 65.** In order to account separately for the service element of an arrangement that includes both software and services, sufficient vendor-specific objective evidence of fair value must exist to permit allocation of the revenue to the various elements of the arrangement (as discussed in paragraphs 10 and 12). Additionally, the services (a) must not be essential to the functionality of any other element of the transaction and (b) must be described in the contract such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services.

- 66.** If an arrangement includes services that meet the criteria of paragraph 65 for separate accounting, revenue should be allocated among the service and software elements of the contract. This allocation should be based on vendor-specific objective evidence of fair values. (Fair values are not necessarily the same as any separate prices stated for the separate elements of the arrangement.) Revenue allocated to the service element should be recognized as the services are performed or, if no pattern of performance is discernible, on a straight-line basis over the period during which the services are performed.
- 67.** If vendor-specific objective evidence of the fair value does not exist to allocate a portion of the fee to the service element, and the only undelivered element is services that do not involve significant production, modification, or customization of the software (for example, training or installation), the entire arrangement fee should be recognized as the services are performed. If no pattern of performance is discernible, the entire arrangement fee should be recognized on a straight-line basis over the period during which the services are performed.
- 68.** An important factor to consider in determining whether the services are essential to the functionality of any other element is whether the software included in the arrangement is considered **core** or **off-the-shelf software**. Core software is software that a vendor uses in creating other software. It is not sold as is because customers cannot use it unless it is customized to meet system objectives or customer specifications. Off-the-shelf software is software that is marketed as a stock item that can be used by customers with little or no customization.
- 69.** Software should be considered off-the-shelf software if it can be added to an arrangement with insignificant changes in the underlying code and it could be used by the customer for the customer's purposes upon installation. Actual use by the customer and performance of other elements of the arrangement is not required to demonstrate that the customer could use the software off-the-shelf. If significant modifications or additions to the off-the-shelf software are necessary to meet the customer's purpose (for example,

changing or making additions to the software, or because it would not be usable in its off-the-shelf form in the customer's environment), the software should be considered core software for purposes of that arrangement. If the software that is included in the arrangement is not considered to be off-the-shelf software, or if significant modifications or additions to the off-the-shelf software are necessary to meet the customer's functionality, no element of the arrangement would qualify for accounting as a service, and contract accounting should be applied to both the software and service elements of the arrangement.

70. Factors indicating that the service element is essential to the functionality of the other elements of the arrangement, and consequently should not be accounted for separately, include the following.

- The software is not off-the-shelf software.
- The services include significant alterations to the features and functionality of the off-the-shelf software.
- Building complex interfaces is necessary for the vendor's software to be functional in the customer's environment.
- The timing of payments for the software is coincident with performance of the services.
- Milestones or customer-specific acceptance criteria affect the realizability of the software-license fee.

71. Judgment is required in determining whether the obligation to provide services in addition to the delivery of software should be accounted for separately as a service element. Services that qualify for accounting as a service element of a software arrangement always are stated separately and have one or more of the following characteristics.

- The services are available from other vendors.
- The services do not carry a significant degree of risk or unique acceptance criteria.
- The software vendor is an experienced provider of the services.

- The vendor is providing primarily implementation services, such as implementation planning, loading of software, training of customer personnel, data conversion, building simple interfaces, running test data, and assisting in the development and documentation of procedures.
- Customer personnel are dedicated to participate in the services being performed.

72. *Funded Software-Development Arrangements.* Software-development arrangements that are fully or partially funded by a party other than the vendor that is developing the software typically provide the funding party with some or all of the following benefits:

- Royalties payable to the funding party based solely on future sales of the product by the software vendor (that is, reverse royalties)
- Discounts on future purchases by the funding party of products produced under the arrangement
- A nonexclusive sublicense to the funding party, at no additional charge, for the use of any product developed (a prepaid or paid-up nonexclusive sublicense)

73. A funded software-development arrangement within the scope of FASB Statement No. 68, *Research and Development Arrangements*, should be accounted for in conformity with that Statement. If the technological feasibility of the computer software product pursuant to the provisions of FASB Statement No. 86 has been established before the arrangement has been entered into, FASB Statement No. 68 does not apply because the arrangement is not a research and development arrangement. Accounting for costs related to funded software-development arrangements is beyond the scope of this SOP. However, if capitalization of the software-development costs commences pursuant to FASB Statement No. 86, any income from the funding party under a funded software-development arrangement should be credited first to the amount of the development costs capitalized. If the income from the funding party exceeds the amount of development costs capitalized, the excess should be deferred and credited against future amounts that

subsequently qualify for capitalization. Any deferred amount remaining after the project is completed (that is, when the software is available for general release to customers and capitalization has ceased) should be credited to income.

Contract Accounting

- 74.** If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the service element does not meet the criteria for separate accounting set forth in paragraph 65. The entire arrangement should be accounted for in conformity with ARB No. 45, using the relevant guidance in SOP 81-1. Nevertheless, transactions that normally are accounted for as product sales should not be accounted for as long-term contracts merely to avoid the delivery requirements normally associated with product sales for revenue recognition.
- 75.** In applying contract accounting, the vendor must use either the percentage-of-completion method or the completed-contract method. The determination of the appropriate method should be made according to the recommendations in paragraphs 21 through 33 of SOP 81-1.
- 76.** *Segmentation.* Software contracts may have discrete elements that meet the criteria for segmenting in paragraphs 39 to 42 of SOP 81-1. If a contract is segmented, each segment is treated as a separate profit center. Progress-to-completion for each segment should be measured in conformity with paragraphs 78 to 80 of this SOP.
- 77.** Some vendors of arrangements that include software combined with services or hardware or both do not identify the elements separately and do not sell them separately because of agreements with their suppliers. Other vendors who are not restricted by such agreements nevertheless bid or negotiate software and other products and services together. Arrangements that do not meet the segmentation criteria in paragraph 40 of SOP 81-1 are prohibited from being segmented, unless the vendor has a history of providing the software and other products and services to cus-

tomers under separate arrangements and the arrangement meets the criteria in paragraph 41 of SOP 81-1.

- 78. *Measuring Progress-to-Completion Under the Percentage-of-Completion Method.*** Paragraph 46 of SOP 81-1 describes the approaches to measuring progress on contracts (or segments thereof) under the percentage-of-completion method. Those approaches are grouped into input and output measures, as follows.

Input measures are made in terms of efforts devoted to a contract. They include the methods based on costs and on efforts expended. Output measures are made in terms of results achieved. They include methods based on units produced, units delivered, contract milestones, and value added. For contracts under which separate units of output are produced, progress can be measured on the basis of units of work completed.

For software contracts, an example of an input measure is labor hours; an example of an output measure is arrangement milestones, such as the completion of specific program modules.

- 79.** If, as discussed in paragraph 76 of this SOP, a software contract includes a discrete element that meets the segmentation criteria of SOP 81-1, the method chosen to measure progress-to-completion on the element should be the method that best approximates progress-to-completion. Progress-to-completion on separate elements of the same software arrangement may be measured by different methods. The software vendor should choose measurement methods consistently, however, so that it uses similar methods to measure progress-to-completion on similar elements.
- 80.** Output measures, such as value-added or arrangement milestones, may be used to measure progress-to-completion on software arrangements, but many companies use input measures because they are established more easily. As noted in paragraph 47 of SOP 81-1, "The use of either type of measure requires the exercise of judgment and the careful tailoring of the measure to the circumstances." Further, paragraph 51 of SOP 81-1 states that

The acceptability of the results of input or output measures deemed to be appropriate to the circumstances

should be periodically reviewed and confirmed by alternative measures that involve observation and inspection. For example, the results provided by the measure used to determine the extent of progress may be compared to the results of calculations based on physical observations by engineers, architects, or similarly qualified personnel. That type of review provides assurance somewhat similar to that provided for perpetual inventory records by periodic physical inventory counts.

- 81. *Input Measures.*** Input measures of progress-to-completion on arrangements are made in terms of efforts devoted to the arrangement and, for software arrangements, include methods based on costs, such as cost-to-cost measures, and on efforts expended, such as labor hours or labor dollars. Progress-to-completion is measured indirectly, based on an established or assumed relationship between units of input and productivity. A major advantage of input measures is that inputs expended are easily verifiable. A major disadvantage is that their relationship to progress-to-completion may not hold if inefficiencies exist or if the incurrence of the input at a particular point does not indicate progress-to-completion.
- 82.** Costs incurred should be included in measuring progress-to-completion only to the extent that they relate to contract performance. Items not specifically produced for the arrangement, such as hardware purchased from third parties or off-the-shelf software, should not be included in the measurement of progress-to-completion.
- 83.** Labor hours often are chosen as the basis for measuring progress-to-completion, because they closely approximate the output of labor-intensive processes and often are established more easily than output measures. Core software requires labor-intensive customization. Therefore, labor hours provide a good measure of progress-to-completion on elements of software arrangements that involve the customization of core software.
- 84.** If the measurement of progress-to-completion is based primarily on costs, the contribution to that progress of hardware and software that were produced specifically for the arrangement may be measurable and recognizable before

delivery to the user's site. For example, efforts to install, configure, and customize the software may occur at the vendor's site. The costs of such activities are measurable and recognizable at the time the activities are performed.

- 85. *Output Measures.*** Progress on arrangements that call for the production of identifiable units of output can be measured in terms of the value added or milestones reached. Although progress-to-completion based on output measures is measured directly from results achieved, thus providing a better approximation of progress than is provided by input measures, output measures may be somewhat unreliable because of the difficulties associated with establishing them.
- 86.** In order for the value added to be verifiable, the vendor must identify elements or subcomponents of those elements. If output measures are neither known nor reasonably estimable, they should not be used to measure progress-to-completion.
- 87.** If value added by off-the-shelf software is to be included in the measurement of progress-to-completion, such software cannot require more than minor modifications and must be usable by the customer for the customer's purpose in the customer's environment. If more than minor modifications or additions to the off-the-shelf software are necessary to meet the functionality required under the arrangement terms, either by changing or making additions to the software, or because the software would not be usable by the customer in its off-the-shelf form for the customer's purpose in the customer's environment, it should be accounted for as core software.
- 88.** Value added by the customization of core software should be included in the measurement of progress-to-completion of the customization and installation at the user's site. However, if the installation and customization processes are divided into separate output modules, the value of core software associated with the customization of a module should be included in the measurement of progress-to-completion when that module is completed.
- 89.** Contract milestones may be based on contractual project plans. Contractual provisions generally require the perfor-

mance of specific tasks with the approval or acceptance by the customer; project plans generally schedule inspections in which the project's status is reviewed and approved by management. The completion of tasks that trigger such inspections are natural milestones because they are subject to relatively independent review as an intrinsic part of the project management process.

90. Considerations other than progress-to-completion affect the amounts that become billable at particular times under many arrangements. Accordingly, although the achievement of contract milestones may cause arrangement revenues to become billable under the arrangement, the amounts billable should be used to measure progress-to-completion only if such amounts indeed indicate such progress.
91. The milestones that are selected to measure progress-to-completion should be part of the management review process. The percentage-of-completion designated for each milestone should be determined considering the experience of the vendor on similar projects.

Effective Date and Transition

92. This SOP is effective for transactions entered into in fiscal years beginning after December 15, 1997. Earlier application is encouraged as of the beginning of fiscal years or interim periods for which financial statements or information have not been issued. Retroactive application of the provisions of this SOP is prohibited.

<p>The provisions of this Statement need not be applied to immaterial items.</p>

Basis for Conclusions

Background

93. SOP 91-1 was issued in December 1991. AcSEC understands that certain provisions of that Statement are being applied inconsistently in practice and that various practice

issues have arisen that were not addressed in SOP 91-1. As a result, AcSEC added a project to its agenda in March 1993 to interpret those provisions and provide additional guidance. The key issues identified at the outset of the project related to accounting for arrangements that provided for multiple deliverables (including PCS). The project began as an amendment to SOP 91-1. However, as deliberations progressed, AcSEC determined that it would be more appropriate to supersede SOP 91-1 to (a) amend the provisions in question and (b) incorporate AcSEC's conclusions on practice issues that had not been addressed in SOP 91-1.

Basic Principles

- 94.** Transfers of rights to software by licenses rather than by outright sales protect vendors from the unauthorized duplication of their products. Nevertheless, the rights transferred under software licenses are substantially the same as those expected to be transferred in sales of other kinds of products. AcSEC believes the legal distinction between a license and a sale should not cause revenue recognition on software products to differ from revenue recognition on the sale of other kinds of products.
- 95.** Arrangements to deliver software or a software system, either alone or together with other products, may include services. AcSEC believes that if those services entail significant production, modification, or customization of the software, such software before those alterations (even if already delivered) is not the product that has been purchased by the customer. Instead, the product purchased by the customer is the software that will result from the alterations. Accordingly, AcSEC concluded that arrangements that include services that entail significant production, modification, or customization of software are construction-type or production-type contracts, and should be accounted for in conformity with ARB No. 45 and SOP 81-1. AcSEC concluded that if the services do not entail significant production, modification, or customization of software, the service element should be accounted for as a separate element.

- 96.** AcSEC believes that revenue generally should not be recognized until the element has been delivered. The recognition of revenue from product sales on delivery is consistent with paragraphs 83(b) and 84 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*. Paragraph 83(b) provides the following guidance for recognition of revenues.

Revenues are not recognized until earned. An entity's revenue-earning activities involve *delivering* or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. [Footnote omitted][Emphasis added]

Paragraph 84 states that in recognizing revenues and gains

[t]he two conditions [for revenue recognition] (being realized or realizable and being earned) are usually met by the time the product or merchandise is delivered...to customers, and revenues...are commonly recognized at time of sale (usually meaning *delivery*). [Emphasis added]

- 97.** SOP 91-1 did not address arrangements that included software that was deliverable only when-and-if-available. Implementation questions arose as to whether when-and-if-available terms created contingencies that could be disregarded in determining whether an arrangement consists of multiple elements. AcSEC believes that because the when-and-if-available deliverables are bargained for in arrangements, they are of value to the customer. Accordingly, AcSEC concluded that when-and-if-available deliverables should be considered in determining whether an arrangement consists of multiple elements. Thus, the requirements of this SOP with respect to arrangements that consist of multiple elements should be applied to all additional products and services specified in the arrangement, including those described as being deliverable only when-and-if-available.
- 98.** In SOP 91-1, the accounting for vendor obligations remaining after delivery of the software was dependent upon whether the obligation was significant or insignificant. However,

these determinations were not being made in a consistent manner, leading to a diversity in practice. AcSEC believes that all obligations should be accounted for and that revenue from an arrangement should be allocated to each element of the arrangement, based on vendor-specific objective evidence of the fair values of the elements. Further, AcSEC concluded that revenue related to a particular element should not be recognized until the revenue-recognition conditions in paragraphs 8 to 14 of this SOP are met, because the earnings process related to that particular element is not considered complete until that time.

- 99.** In paragraph 10 of this SOP, AcSEC concluded that the revenue from an arrangement should be allocated to the separate elements based on vendor-specific objective evidence of fair value, regardless of any separate prices stated in the contract for each element. AcSEC believes that separate prices stated in a contract may not represent fair value and, accordingly, might result in an unreasonable allocation of revenue. AcSEC believes that basing the allocation on fair values is consistent with the accounting for commingled revenue. An example is the following discussion in paragraph 12 of FASB Statement No. 45, *Accounting for Franchise Fee Revenue*.

The franchise agreement ordinarily establishes a single initial franchise fee as consideration for the franchise rights and the initial services to be performed by the franchisor. Sometimes, however, the fee also may cover tangible property, such as signs, equipment, inventory, and land and building. In those circumstances, the portion of the fee applicable to the tangible assets shall be based on the fair value of the assets.

- 100.** AcSEC considered allowing the use of surrogate prices such as competitor prices for similar products or industry averages to determine fair value. However, AcSEC believes that inherent differences exist between elements offered by different vendors. These inherent differences led AcSEC to conclude that only vendor-specific evidence of fair value can be considered sufficiently objective to allow the allocation of the revenue to the various elements of the arrangement.

- 101.** AcSEC believes that the best evidence of the fair value of an element is the price charged if that element is sold separately. Still, an arrangement may include elements that are not yet being sold separately. As discussed in the previous paragraph, because of inherent differences between the elements offered by different vendors, AcSEC concluded that companies should not use surrogate prices, such as competitor prices for similar products or industry averages, as evidence of the fair value for an element. AcSEC believes, however, that if a price for the element has been established by management having the relevant authority, such a price represents evidence of the fair value for that element. To meet the criterion of objectivity, it must be probable that the established price will not change before the introduction of the element to the marketplace. Thus, the internally established prices should be factual and not estimates. For this reason, AcSEC concluded that the allocations may not be adjusted subsequently.
- 102.** AcSEC is aware that the pricing structure of certain arrangements is not limited to the prices charged for the separate elements. Pricing may be based on many different factors or combinations thereof. For example, certain arrangements are priced based on a combination of (a) the prices of products to be licensed and (b) the number of users that will be granted access to the licensed products. In some of these arrangements, the vendor requires a minimum number of users.
- 103.** The products contained in such arrangements are not available to the customer at the prices charged in the arrangement unless the customer also pays for the minimum number of users. Therefore, the prices contained in the arrangement do not represent the prices charged for the product when sold separately. AcSEC believes that it would be inappropriate to determine the fair values of the products (as discussed in paragraph 10) without giving consideration to the impact of the user-based portion of the fee. For this reason, AcSEC concluded in paragraph 10 that when a vendor's pricing is based on multiple factors such as the number of products and the number of users, the price charged for the same element when sold separately must consider all factors of the vendor's pricing structure.

- 104.** Often, multiple element arrangements are sold at a discount rather than at the sum of the list prices for each element. If the amounts deferred for undelivered elements were based on list prices, the amount of revenue recognized for delivered elements would be understated. Accordingly, AcSEC concluded that relative sales prices should be used in determining the amount of revenue to be allocated to the elements of an arrangement.
- 105.** AcSEC believes that if an undelivered element is essential to the functionality of a delivered element, the customer does not have full use of the delivered element. Consequently, AcSEC concluded that delivery is considered not to have occurred in such situations.
- 106.** AcSEC believes that the earnings process with respect to delivered products is not complete if fees allocated to those products are subject to forfeiture, refund, or other concession if the vendor does not fulfill its delivery responsibilities. AcSEC believes that the potential concessions indicate the customer would not have licensed the delivered products without also licensing the undelivered products. Accordingly, AcSEC concluded that in order to recognize revenue, persuasive evidence should exist that fees allocated to delivered products are *not* subject to forfeiture, refund, or other concession. In determining the persuasiveness of the evidence, AcSEC believes that a vendor's history of making concessions that were not required by the provisions of an arrangement is more persuasive than terms included in the arrangement that indicate that no concessions are required.

Delivery

- 107.** In paragraph 18 of this SOP, AcSEC concluded that for software that is delivered electronically, the delivery criterion of paragraph 8 is deemed to have been met when the customer either (a) takes possession of the software via a download or (b) has been provided with access codes that allow the customer to take immediate possession of the software on its hardware pursuant to an agreement or purchase order for the software. AcSEC believes that the delivery criterion is

met by use of access codes only when software is being delivered electronically.

- 108.** AcSEC believes that if the fee is not based on the number of copies to be delivered to or made or deployed by the customer, duplication of the software may be incidental to the arrangement. Paragraph 21 of this SOP describes circumstances (arrangements in which duplication is required only if additional copies are requested by the customer; arrangements in which the licensing fee is payable even if no additional copies are requested) that would lead to a conclusion that duplication is incidental to the arrangement. In other arrangements, vendors insist on duplicating the software to maintain quality control or to protect software transmitted by telecommunications. Others agree to duplicate the software as a matter of convenience to the customer.
- 109.** In arrangements in which duplication is considered incidental, AcSEC believes the vendor has fulfilled its delivery obligation as soon as the first copy or product master of the software has been delivered. Therefore, AcSEC concluded that in such instances, the vendor should not be precluded from recognizing revenue if the customer has not requested additional copies (particularly since the fee is payable regardless of whether such additional copies are requested by the customer). However, the estimated costs of duplicating the software should be accrued when the revenue is recognized.

Fixed or Determinable Fees and Collectibility

- 110.** In paragraphs 27 through 30, in the discussion of factors that affect the determination of whether a fee is fixed or determinable, AcSEC sought to clarify—but not change—similar provisions in SOP 91-1. In practice, some had interpreted those provisions to mean the following.
- Extended payment considerations could be overcome if customers were creditworthy.
 - A fee could never be considered fixed or determinable if payment terms extended for more than twelve months after delivery.

111. Others had interpreted these provisions to mean the following.

- If payment terms extended beyond customary terms but were twelve months or less, they were fixed or determinable.
- If payment terms exceeded twelve months, a vendor could recognize amounts due in the first twelve months as revenue at the time of the license. Additional revenue would be recognized based on the passage of time such that, at any point, any amounts due within one year would have been recognized as revenue (the *rolling twelve months* approach).

Paragraphs 112 through 114 of this SOP—

- Explain that the concern with extended payment terms is technological obsolescence and similar factors, not customer creditworthiness.
- Describe circumstances in which the presumption that a fee is not fixed or determinable because of extended payment terms may be overcome.
- Confirm that any extended payment terms, even if for less than twelve months, must be assessed for their effects on the fixed or determinable aspects of the fee.
- Clarify that the rolling twelve months approach should not be used.

112. AcSEC believes that, given the susceptibility of software to significant external factors (in particular, technological obsolescence), the likelihood of vendor refunds or concessions is greater in an arrangement with extended payment terms than in an arrangement without extended payment terms. This is true regardless of the creditworthiness of the customer. Because of this greater likelihood of refunds or concessions, AcSEC believes that *any* extended payment terms outside of a vendor's normal business practices may indicate that the fee is not fixed or determinable.

113. In paragraph 28 of this SOP, AcSEC concluded that if payment of a significant portion of a licensing fee is not due until after the expiration of the license or more than twelve

months after delivery, the fee should be *presumed* not to be fixed or determinable. This conclusion is based on AcSEC's belief that payment terms of such extended duration indicate that vendor refunds or concessions are more likely than not. AcSEC acknowledges that the one-year provision is arbitrary. However, AcSEC concluded that such a limitation is needed to provide greater comparability within the industry.

114. In considering the rolling twelve months approach found in practice, AcSEC considered the guidance in Chapter 1A of ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, paragraph 1, which states that "Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured." Accordingly, if a fee is considered fixed or determinable, it should be recognized as revenue when the sale is effected. If not, AcSEC believes that it should be recognized as revenue as payments from customers become due.

115. In paragraph 8 of this SOP, AcSEC concluded that collectibility must be probable before revenue may be recognized. This conclusion is based on paragraph 84g of FASB Concepts Statement No. 5, which reads

If collectibility of assets received for product, services, or other assets is doubtful, revenues and gains may be recognized on the basis of cash received.

116. AcSEC notes that requiring collectibility enhances the verifiability of the other revenue recognition criteria of paragraph 8, as discussed below.

- *Persuasive evidence of an arrangement.* AcSEC included this criterion in order to prevent revenue recognition on delivery of elements which, in fact, had not been ordered by a customer. AcSEC believes it is unlikely that a customer would pay for an element that had not been ordered. Therefore, AcSEC believes that requiring collectibility of a receivable related to the sale or license acts to verify that an arrangement does exist.

- *Delivery.* AcSEC believes that until delivery of an element has occurred (including delivery of all other items essential to the functionality of the element in question), the customer has not received full use of the element ordered. A customer that has not received full use of the element ordered is likely to withhold payment or require a refund. Therefore, AcSEC believes that requiring collectibility of a receivable related to the sale or license acts to verify that the element has been delivered.
- *Fixed or determinable fee.* Much of AcSEC's concern related to fixed or determinable fees relates to arrangements with extended payment terms. In the software industry, requiring collectibility of a receivable prior to revenue recognition is important because of the frequency with which upgrades, enhancements, or new versions are released. As discussed elsewhere in this SOP, in certain instances it may be difficult to determine which version of an element induced a customer to enter into an arrangement. By requiring collectibility, AcSEC sought to prevent revenue recognition on sales or licenses of an element in situations in which circumstances may prompt the vendor to make subsequent adjustments to the price of a customer's purchase or license of a subsequent version of that element.

The likelihood that subsequent versions will be released is greater over the long term than over the short term. Therefore, concerns related to concessions increase in arrangements with extended payment terms. AcSEC notes that prohibiting revenue recognition in circumstances in which the price adjustments discussed above could occur serves to ensure that the portion of the fee allocated to each element is fixed or determinable. That is, if the price on a subsequent element cannot be adjusted for concessions, and the amount allocated to the initial element must be collected in full, neither amount is subject to adjustment. Therefore, AcSEC believes that requiring collectibility of a receivable related to

the sale or license acts to verify that the fees are fixed or determinable.

Multiple-Element Arrangements

Additional Software Deliverables and Right to Exchange or Return Software

117. *Upgrades/enhancements.* In paragraph 37 of this SOP, AcSEC concluded that the portion of the arrangement fee allocated to an upgrade right should be based on the price for the upgrade/enhancement that would be charged to existing users of the software product being updated. AcSEC believes that in arrangements that include upgrade rights, it may be difficult to determine which version of the software induced the customer to enter into the arrangement. For example, a customer licensing an existing version of the software may have done so to facilitate obtaining the updated version upon its introduction. To eliminate the possibility of allocating too much revenue to the delivered software (and thereby accelerating recognition), AcSEC concluded that the upgrade price (without the allocation of any discount on the arrangement) should be used to determine the amount to be deferred. The residual amount, if any, is considered to be the fair value of the original product.

118. AcSEC believes that upgrades/enhancements do not necessarily contain improvements that all customers would desire. A customer may not exercise an upgrade right for various reasons, including any of the following.

- a.** The benefits to be gained from the related upgrade/enhancement may not be important to that customer.
- b.** The customer may not wish to learn new commands for what may be perceived by that customer as marginal improvements.
- c.** The upgrade/enhancement would require more hardware functionality than the customer currently has.

Consequently, AcSEC concluded that amounts allocated to upgrade rights should be reduced to reflect the percentage of customers not expected to exercise the upgrade right, based on vendor-specific evidence.

119. *Additional Software Products.* As stated in paragraph 118, AcSEC believes that not all customers entitled to an upgrade/enhancement will exercise their upgrade rights. AcSEC believes, however, that it is probable that all customers will choose to receive additional software products. Consequently, AcSEC concluded that the fee allocated to additional software products should not be reduced by the percentage of any customers not expected to exercise the right to receive the additional products.

120. Paragraphs 48 and 49 of this SOP discuss accounting for software arrangements in which vendors agree to deliver unspecified additional software products in the future. AcSEC concluded that such arrangements should be accounted for as subscriptions, and that the fee from the arrangement should be recognized ratably as revenue over the term of the arrangement. AcSEC notes that, because the vendor is obligated to deliver these items only if they become available during the term of the arrangement, in some situations, the delivery of additional products will not be required. AcSEC believes that because these items are unspecified, vendor-specific objective evidence of fair value of each unspecified additional product cannot exist. However, AcSEC believes that requiring the deferral of all revenue until the end of the arrangement is too onerous because of the following.

- a. All other revenue-recognition conditions in paragraphs 8 through 14 of this SOP have been met.
- b. The additional software products in fact may never be delivered.

However, AcSEC also was concerned that if revenue recognition were permitted to begin at the inception of the arrangement, revenue may be recognized too early, particularly in arrangements in which the first product was not delivered for some time after inception. Accordingly, AcSEC concluded that revenue from the arrangement should be recognized ratably over the term of the arrangement beginning with the delivery of the first product.

121. *Rights to Exchange or Return Software.* AcSEC believes that the rights to exchange or return software (including platform transfer rights) are subject to the provisions of

FASB Statement No. 48, even if the software is not returned physically. Accordingly, AcSEC concluded that the accounting for exchanges of software for products with no more than minimal differences in price, functionality, and features by *users* qualify for exchange accounting because, as discussed in footnote 3 to FASB Statement No. 48, (a) users are “ultimate customers” and (b) exchanges of software with no more than minimal differences in price, functionality, and features represent “exchanges... of one item for another of the same kind, quality, and price.” AcSEC concluded that because resellers are not “ultimate customers,” such exchanges by resellers should be considered returns.

- 122.** AcSEC reached similar conclusions related to certain platform-transfer rights. Additionally, AcSEC concluded that in situations in which customers are entitled to continue using the software that was originally delivered (in addition to the software that is to be delivered for the new platform), the customer has received additional software products, and the platform-transfer right should be accounted for as such. Other platform-transfer rights do not allow customers to continue to use the software on the original platform. Those platform-transfer rights should be accounted for as exchange rights or rights of return.
- 123.** It is possible that exchange rights may be granted for software that has not been developed for other platforms at the time revenue from the arrangement is recorded. AcSEC did not address the issue of whether such future development costs related to deliverable software, for which no further revenue will be received, should be capitalized pursuant to FASB Statement No. 36 because it was believed that such costs would not be significant. Accordingly, AcSEC concluded that in the event of significant development costs, the vendor would not be likely to be able to demonstrate persuasively that the future software would have similar pricing, features, and functionality, and would be marketed as the same product (that is, qualify as an exchange for accounting purposes). In that event, the vendor has granted a return right that must be accounted for pursuant to FASB Statement No. 48.

Postcontract Customer Support

- 124.** An obligation to perform PCS is incurred at the inception of a PCS arrangement and is discharged by delivering unspecified upgrades/enhancements, performing services, or both over the period of the PCS arrangement. The obligation also may be discharged by the passage of time. AcSEC concluded that because estimating the timing of expenditures under a PCS arrangement usually is not practicable, revenue from PCS generally should be recognized on a straight-line basis over the period of the PCS arrangement. However, AcSEC also concluded that if there is sufficient vendor-specific historical evidence that costs to provide the support are incurred on other than a straight-line basis, the vendor should recognize revenue in proportion to the amounts expected to be charged to the PCS services rendered during the period.
- 125.** SOP 91-1 required that revenue from both the PCS and the initial licensing fee be recognized ratably over the period of the PCS arrangement if no basis existed to derive separate prices for the PCS and the initial licensing fee. Diversity in practice arose as to what constituted a sufficient basis in arrangements involving vendors that did not have a basis to derive a separate price for the PCS. In this SOP, AcSEC has concluded that arrangement fees must be allocated to elements of the arrangement based on vendor-specific objective evidence of fair value. Because AcSEC determined that the evidence should be limited to that which is specific to the vendor, AcSEC believes that vendors that do not sell PCS separately have no basis on which to allocate fair values. AcSEC concluded that the total arrangement fee should be recognized in accordance with the provisions on recognition of PCS revenues. AcSEC also believes that, because a substantial portion of the arrangement fee typically is represented by the delivered software (rather than the performance of support), requiring the deferral of all revenues until the PCS obligation is fully satisfied would be too onerous. Accordingly, AcSEC concluded that, as discussed in the previous paragraph, the total arrangement fee generally should be recognized ratably over the period of the PCS arrangement.

Services

- 126.** Certain software arrangements include both a software element and an obligation to perform non-PCS services. SOP 91-1 provided guidance on the conditions that must be met in order to account for the obligation to provide services separately from the software component. AcSEC is aware that this guidance has been interpreted in varying ways, leading to a diversity in practice. During its deliberations on this SOP, AcSEC reached conclusions intended to clarify this issue, but did not redeliberate the other conclusions related to services that were included in SOP 91-1.
- 127.** AcSEC believes the service element should be accounted for separately if the following occur.
- a.** All other revenue allocation provisions of this SOP are met.
 - b.** The services are not essential to the functionality of any other element in the arrangement.
 - c.** The service and product elements are stated separately such that the total price of the arrangement would vary as a result of inclusion or exclusion of the services.

Accordingly, AcSEC concluded that a service element need not be *priced* separately in an agreement in order to account for the services separately. AcSEC believes that this conclusion represents the original intent of SOP 91-1, and wishes to clarify the language at this time.

- 128.** Paragraphs 129 to 132 of this SOP are carried forward from SOP 91-1 with certain editorial changes.
- 129. *Service Elements.*** Footnote 1 to paragraph 11 of SOP 81-1 excludes service transactions from the scope of the SOP, as follows.

This statement is not intended to apply to “service transactions” as defined in the FASB’s October 23, 1978 Invitation to Comment, *Accounting for Certain Service Transactions*. However, it applies to separate contracts to provide services essential to the construction or production of tangible property, such as design... [and] engineering....

130. The previously mentioned Invitation to Comment, which was based on an AICPA-proposed SOP, was issued in 1978. The FASB later included service transactions as part of its project to develop general concepts for revenue recognition and measurement. The resulting FASB Concepts Statement No. 5, however, does not address service transactions in detail. Nevertheless, some of the concepts on service transactions developed in the Invitation to Comment are useful in accounting for certain software transactions.

131. A service transaction is defined in paragraphs 7 and 8 of the Invitation to Comment as follows.

A transaction between a seller and a purchaser in which, for a mutually agreed price, the seller performs... an act or acts... that do not alone produce a tangible commodity or product as the principal intended result... A service transaction may involve a tangible product that is sold or consumed as an incidental part of the transaction or is clearly identifiable as secondary or subordinate to the rendering of the service.

The term *service transaction* is used in the same sense in this SOP but, as used in this SOP, does not apply to PCS. Items classified as tangible products in software service transactions generally should be limited to off-the-shelf software or hardware.

132. This SOP, like the Invitation to Comment, recommends the separation of such arrangements with discrete elements into their product and service elements. Paragraph 8(b) of the Invitation to Comment states the following.

If the seller of a product offers a related service to purchasers of the product but separately states the service and product elements in such a manner that the total transaction price would vary as a result of the inclusion or exclusion of the service, the transaction consists of two components: a product transaction that should be accounted for separately as such and a service transaction.

Contract Accounting

133. SOP 91-1 included guidance on the application of contract accounting to software transactions. Questions arose as to

whether output measures could be used to measure progress-to-completion if the amounts recorded would differ from those that would have been reported had input measures been used. During its deliberations of this SOP, AcSEC reached conclusions intended to clarify this issue, but did not redeliberate the other conclusions related to services that were included in SOP 91-1.

- 134.** AcSEC believes that the method chosen to measure progress-to-completion on an individual element of a contract should be the method that best approximates progress-to-completion on that element. Accordingly, AcSEC concluded that output measures may be used to measure progress-to-completion, provided that the use of output measures results in “the method that best approximates progress-to-completion.”
- 135.** Paragraphs 136 to 142 of this SOP are carried forward from SOP 91-1 with certain editorial changes.
- 136.** ARB No. 45 established the basic principles for measuring performance on contracts for the construction of facilities or the production of goods or the provision of related services with specifications provided by the customer. Those principles are supplemented by the guidance in SOP 81-1.

Distinguishing Transactions Accounted for Using Contract Accounting From Product Sales

- 137.** SOP 81-1 suggests that transactions that normally are accounted for as product sales should not be accounted for using contract accounting merely to avoid the delivery requirements for revenue recognition normally associated with product sales. Paragraph 14 of SOP 81-1 states the following:

Contracts not covered... include... [s]ales by a manufacturer of goods produced in a standard manufacturing operation, even if produced to buyers' specifications, and sold in the ordinary course of business through the manufacturer's regular marketing channels if such sales are normally recognized as revenue in accordance with the realization principle for sales of products and if their costs are accounted for in accordance with generally accepted principles of inventory costing.

Application of ARB No. 45 and SOP 81-1

138. SOP 81-1 provides guidance on the application of ARB No. 45 that applies to a broad range of contractual arrangements. Paragraph 1 of SOP 81-1 describes contracts that are similar in nature to software arrangements, and paragraph 13 includes the following kinds of contracts within the scope of that SOP:

- Contracts to design, develop, manufacture, or modify complex... electronic equipment to a buyer's specification or to provide services related to the performance of such contracts
- Contracts for services performed by... engineers... or engineering design firms

139. ARB No. 45 presumes that percentage-of-completion accounting should be used when the contractor is capable of making reasonable estimates. Paragraph 15 of ARB No. 45 states the following:

[I]n general when estimates of costs to complete and extent of progress toward completion of long-term contracts are reasonably dependable, the percentage-of-completion method is preferable. When lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed-contract method is preferable.

Evidence to consider in assessing the presumption that the percentage-of-completion method of accounting should be used includes the technological risks and the reliability of cost estimates, as described in paragraphs 25, 26, 27, 32, and 33 of SOP 81-1.

140. Paragraph 24 of SOP 81-1 specifies a further presumption that a contractor is capable of making reasonable estimates and states the following:

[T]he presumption is that [entities]... have the ability to make estimates that are sufficiently dependable to justify the use of the percentage-of-completion method of accounting. Persuasive evidence to the contrary is necessary to overcome that presumption. [Footnote omitted]

141. Although cost-to-cost measures may be verified easily, they tend to attribute excessive profit to the hardware elements

of arrangements with combined software and hardware elements for contracts under which segmentation is not permitted. Although the hardware elements of such arrangements have high cost bases, they generally yield relatively low profit margins to vendors. Furthermore, if excessive revenue is attributed to the hardware element, revenue recognition on the arrangement becomes overly dependent on when that element is included in the measurement of progress-to-completion.

- 142.** For off-the-shelf software elements, the application of the cost-to-cost method produces the opposite effect. The book basis of the software tends to be low, because most of the costs associated with software development frequently are charged to expense when incurred in conformity with FASB Statement No. 86. Although the profit margins associated with software are generally higher than those for other elements of the arrangement, the application of cost-to-cost measures with a single profit margin for the entire arrangement would attribute little or no profit to the off-the-shelf software. Similarly, the application of the cost-to-cost method to arrangements that include core software, which also has a relatively low cost basis, would attribute a disproportionately small amount of profit to the software.

Effective Date and Transition

- 143.** AcSEC concluded that the provisions of this SOP should be applied prospectively and that retroactive application should be prohibited. AcSEC recognizes the benefits of comparable financial statements but is concerned that the application of the provisions of this SOP to contracts existing in prior periods would require a significant amount of judgment. The application of that judgment likely would be influenced by the hindsight a company would have, resulting in judgments based on information that did not exist at the time of the initial judgment but that would be called for if the SOP were to be applied retroactively.
- 144.** Additionally, AcSEC concluded that some entities would be required to incur large expenditures in determining restated amounts or the cumulative effect of adoption. AcSEC concluded that the cost of calculating such amounts

likely would exceed the related benefit of that information. This SOP does not preclude an entity from disclosing in the notes to the financial statements the effect of initially applying this SOP if an entity believes it is practicable to do so.

Items Not Retained From SOP 91-1

- 145.** AcSEC believes that the guidance included in SOP 91-1 related to discounting receivables and the collectibility of receivables (discussed in paragraphs 56 and 78, respectively, of SOP 91-1) is not specific to the software industry and thus does not need to be retained in this SOP.

APPENDIX A

Examples of the Application of Certain Provisions of This Statement of Position

Scope—Example 1

Facts

An automobile manufacturer installs software into an automobile model. This software is used solely in connection with operating the automobile and is not sold or marketed separately. Once installed, the software is not updated for new versions that the manufacturer subsequently develops. The automobile manufacturer's costs for the development of the software that are within the scope of FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, and the production costs of such software are insignificant relative to the other development and production costs of the automobile.

Applicability

The Statement of Position (SOP) is not applicable to such software because the software is deemed incidental to the product as a whole.

Discussion

Although the software may be critical to the operations of the automobile, the software itself is not the focus of the marketing effort, nor is it what the customer perceives he or she is obtaining. The development and production costs of the software as a component of the cost of the automobile is incidental.

Scope—Example 2

Facts

An entity develops interactive training courses for sale or licensing to customers. These courses are delivered on a compact disc, which is loaded onto a customer's computer. The courses are

developed such that, based on the responses received to a particular question, different questions are generated and content of the course material that is displayed is determined in a manner that directs the user's learning experience in a more focused way. The course developer's costs for the development of the software content are within the scope of FASB Statement No. 86 and are significant. The interactive nature of the courses is mentioned prominently in the marketing efforts.

Applicability

The SOP is applicable because the software is not incidental to the product.

Discussion

Although some might say that the product is educational services, the marketing of the product focuses on the software-reliant interactive features. In addition, the course developer incurs significant costs that are within the scope of FASB Statement No. 86. The nature of the relationship between the vendor and the customer is not one in which the customer would have a need for postcontract services. Consequently, the absence of PCS is not presumptive that software is incidental to the product. Accordingly, a conclusion is reached that the software is not incidental to the product as a whole. Therefore, the provisions of the SOP apply.

Additional Software Products—Price per Copy— Example 1

Facts

A vendor enters into an arrangement under which a customer has the right to make copies of Product A at \$100 a copy, copies of Product B at \$200 a copy, or copies of Product C at \$50 a copy until such time as the customer has made copies aggregating \$100,000 based on the per copy prices. The customer is obligated to pay the \$100,000 whether or not the customer makes all the copies to which it is entitled under the arrangement. In all other respects, the \$100,000 is considered to meet the criteria of a fixed fee, as described in this SOP.

Master copies of products A and B are available currently and have been delivered. Product C is not available yet; therefore, no master copy has been delivered. The contract is clear that no portion of the fee allocable to copies made of products A and B is refundable if Product C is not delivered, nor is there any further obligation to

deliver product C if copies of products A and B aggregating \$100,000 have been made. The per copy prices included in the arrangement for Products A and B are the per copy prices included in the company's price list, and the company has already approved the per copy price list for Product C to be \$50 per copy. Product C is not essential to the functionality of Products A or B. The maximum number of copies of Product C that can be made is 500.

Revenue Recognition

The vendor should allocate \$25,000 of the arrangement fee to Product C. The remaining \$75,000 of revenue should be recognized when the master copies of Products A and B are delivered to the customer. The \$25,000 allocated to Product C would be recognized when the master copy of Product C is delivered to the customer. If the customer duplicates enough copies of Products A and B so that the revenue allocable to those products exceeds \$75,000, the additional revenue should be recognized as the additional copies are made.

Discussion

As discussed in paragraph 43 of this SOP, in an arrangement in which a number of products are not deliverable or specified at the inception of the arrangement, an allocation of the arrangement fee generally cannot be made, because the total revenue allocable to each software product is unknown and depends on choices to be made by the customer and, sometimes, future development activity. As discussed in paragraph 46 of this SOP, however, if such an arrangement specifies a maximum number of copies of the undeliverable or unspecified product, a portion of the arrangement fee should be allocated to the undeliverable product(s). This allocation should be made assuming the customer elects to receive the maximum number of copies of the undeliverable product(s).

Because the arrangement states a maximum number of copies of Product C that can be made, a basis for allocating the fair value to each product of the arrangement exists. The amount allocated to the undelivered product is the maximum amount that can be allocable to that product, based on the maximum number of copies of Product C that can be made (500) and the fee per copy (\$50). Accordingly, \$25,000 should be allocated to Product C and deferred until delivery of the product master. Because all other conditions for revenue recognition in this SOP have been met, revenue related to Products A and B may be recognized upon delivery of the masters of those products as discussed in paragraph 44 of this SOP.

Additional Software Products—Price per Copy— Example 2

Facts

Assume the same facts as in the preceding example, except the arrangement does not state a maximum number of copies of Product C that can be made.

Revenue Recognition

Revenue should be recognized as copies of Products A (\$100 of revenue per copy) and B (\$200 of revenue per copy) are made, until the master of Product C is delivered to the customer. Any remaining revenue should be recognized upon delivery of the master of Product C.

Discussion

As discussed in paragraph 43 of this SOP, although the fee per copy is fixed at the inception of the arrangement and the cost of duplication is incidental, the total fee allocated to the undelivered software (Product C) is unknown and will depend on the choices made by the customers as to how many copies of each product will be utilized.

Authorization Codes—Example 1

Facts

A vendor includes ten optional functions on a compact disc (CD-ROM) on which its software product is licensed. Access to those optional functions is not available without a permanent key. Users can order the optional functions and receive permanent keys to enable the full use of those functions.

Revenue Recognition

Revenue for each individual optional function should be recognized by the vendor when the user purchases it by placing an order, evidence of such order exists, and the key is delivered to the user.

Discussion

Although the user has received a fully functional version (except for the keys) of the optional functions on the CD-ROM, the user has not agreed to license them. Because no evidence of an

arrangement exists (as discussed in paragraphs 15 to 17 of this SOP), revenue for the optional functions may not be recognized when the CD-ROM is delivered.

Authorization Codes—Example 2

Facts

A software vendor's products run on two different levels of central processing units (CPU) of the same manufacturer—Model X and Model Y (both of which are on the same platform). The vendor enters into a license arrangement with a user whereby the user licenses the vendor's products to run on Model X but allows the user to move to Model Y at no additional charge. The vendor delivers the product in the form of a disc pack along with a CPU authorization code. At the time the user chooses to move to Model Y, the user does not receive a new disc pack; rather the vendor gives the user a new CPU authorization code.

Revenue Recognition

Revenue should be recognized on the delivery of the disc pack.

Discussion

Delivery of the authorization code to move to another CPU is not considered to be an additional software deliverable.

Multiple-Element Arrangements—Products—Example 1

Facts

A vendor licenses a user one license covering a single copy of products A, B, C, and D for a nonrefundable fixed fee of \$80, with no stated price per product. Products A, B, and C are deliverable. Product D is not deliverable and is not essential to the functionality of products A, B, or C. Persuasive evidence exists that indicates that the revenue related to products A, B, or C is not subject to refund, forfeiture, or other concessions if product D is not delivered. The vendor has a history of sales prices for products A, B, and C of \$25 each. The vendor's pricing committee has established a price for product D of \$25. It is probable that the price established by the pricing committee for product D will not change before introduction. Therefore, the vendor is able to derive its specific price for the undelivered software.

Revenue Recognition

Revenue allocated to each product based on the existing prices for products A, B, and C and the probable price for product D should be recognized when each individual product is delivered. The revenue allocated to each of the products would be \$20.

Discussion

Revenue allocated to each product should be recognized upon the delivery of that product if the criteria in paragraphs 8 through 14 of this SOP have been met.

The allocation of revenue to each product is based on the relative fair value of each product. As discussed in paragraph 12 of this SOP, sufficient vendor-specific objective evidence must exist to determine allocation. In this example, sufficient vendor-specific objective evidence exists to determine that the fair value of each product on a stand-alone basis is \$25. Therefore, in accordance with paragraph 41 of this SOP, the discount should be allocated evenly to each product, and revenue of \$20 per product should be recognized when each product is delivered.

Multiple-Element Arrangements—Products— Example 2

Facts

The transaction is the same as that outlined in the prior example. The contract is silent about penalties for the nondelivery of product D, but the proposal and other communications indicate that it is a required capability of the offering and that the user does not want any of the vendor's products unless product D is delivered.

Revenue Recognition

All revenue must be deferred until delivery of product D.

Discussion

Because revenue allocable to the delivered software is subject to forfeiture, refund, or other concession if product D is not delivered, all revenue under the agreement should be deferred until product D is delivered, in accordance with paragraph 13 of this SOP.

Multiple-Element Arrangements—Products— Example 3

Facts

A vendor licenses version 1.0 of a software product to 100 customers for \$300 per copy with a right to receive version 2.0 at no additional cost when it becomes available. The pricing committee has not yet decided whether version 2.0 will be offered to users of version 1.0 for \$100 or for \$200.

Revenue Recognition

All revenue should be deferred until the pricing committee makes its decision and it is probable that the price established will be the price charged upon introduction.

Discussion

Because the pricing committee has not yet decided whether version 2.0 will be offered at \$100 or at \$200, sufficient vendor-specific objective evidence does not yet exist supporting the price of the undelivered software. As discussed in paragraph 12 of this SOP, if sufficient vendor-specific objective evidence does not exist to determine the allocation of revenue, all revenue should be deferred until sufficient vendor-specific objective evidence exists.

Multiple-Element Arrangements—Products— Example 4

Facts

In the preceding example, assume that the pricing committee determines that version 2.0 will be offered to users of version 1.0 as a specified upgrade/enhancement at a price of \$100. It is probable that such price will not change prior to introduction. Persuasive evidence exists indicating that the amount allocated to version 1.0 will not be subject to forfeiture, refund, or other concession. Also, the vendor's experience indicates that 40 percent of customers do not exercise upgrade rights.

Revenue Recognition

The vendor should defer \$6,000 (upgrade price of \$100 multiplied by 100 copies, reduced by 40 percent to account for the customers expected not to exercise the upgrade right) until

delivery of the upgrade/enhancement, and recognize the remaining \$24,000 on delivery of version 1.0.

Discussion

The portion of the arrangement fee allocated to the upgrade right is equal to the price for the upgrade/enhancement determined pursuant to paragraph 37 of this SOP. This amount should be deferred and recognized on the delivery of version 2.0. The amount deferred for the specific upgrade/enhancement should be reduced to reflect the percentage of customers that, based on experience, are not expected to exercise the upgrade right (see paragraph 37 of this SOP). Accordingly, the \$10,000 revenue allocated to the upgrade right should be reduced by \$4,000 (40 percent of the allocated revenue).

If the vendor did not have information based on experience that indicates the percentage of customers that do not exercise the upgrade right, the vendor should defer the entire \$10,000 of revenue allocated to the upgrade right, under the assumption that, in the absence of vendor-specific objective evidence to the contrary, 100 percent of customers will exercise the upgrade right.

Multiple-Element Arrangements—Products and Services—Example 1

Facts

A vendor has entered into an arrangement to provide a customer with its off-the-shelf software product and related implementation services. The software and service elements of the contract are stated separately, and the company has a history of selling these services separately such that the revenue allocation criteria of paragraphs 8 to 14 of this SOP can be satisfied. The software license fees are due under the company's normal trade terms, which are net thirty days. The services are expected to be provided over the next ninety days and are of the type performed routinely by the vendor. The features and functionality of the software are not altered to more than a minor degree as a result of these services.

Revenue Recognition

The vendor should recognize the license revenue allocated to the software element upon its delivery and the revenue allocated to the service element as such services are performed.

Discussion

When license arrangements have multiple elements, revenue should be allocated to each of the elements and recognized when the related element is delivered and the following occur.

1. The undelivered elements are not essential to the functionality of the delivered elements.
2. The revenue allocated to the delivered elements is not subject to forfeiture, refund, or other concession if the undelivered elements are not delivered.
3. Sufficient company-specific objective evidence exists to allocate separate prices to each of the elements.

The service element in this arrangement is not deemed to be essential to the functionality of the software element because the features and functionality of the software are not altered to more than a minor degree as a result of the services.

Multiple-Element Arrangements—Products and Services—Example 2

Facts

Assume the same transaction as described above except that the vendor agrees to make more than minor modifications to the functionality of the product to meet needs as defined by the user. Payment terms are 10 percent upon installation of the software, with the remainder according to a time line, and the final 25 percent withheld until acceptance. The desired modifications are not unusual; the vendor has made similar modifications to the product many times and is certain that the planned modifications will meet the user's needs.

Revenue Recognition

This arrangement should be accounted for pursuant to the guidance on contract accounting (using either the percentage-of-completion or completed-contract method, depending on the facts and circumstances) included in paragraphs 74 to 91 of this SOP.

Discussion

The new conditions would preclude service transaction accounting because the functionality of the software product is being altered in more than a minor way, the payment of the fees is

coincident with the services being performed, and the software is subject to the user's unique acceptance criteria.

Multiple-Element Arrangements—Products and Services—Example 3

Facts

Assume the same transaction as described in “Multiple-Element Arrangements—Products and Services—Example 1,” except that the vendor never sells implementation services separately. The implementation services do not involve significant customization of the software.

Revenue Recognition

The vendor should recognize all revenue from the arrangement over the ninety-day period during which the services are expected to be performed, commencing with delivery of the software product.

Discussion

The criteria for vendor-specific objective evidence of the fair value require that the element be sold separately or be planned to be sold separately. Because implementation services are neither sold separately nor planned to be sold separately, and upon delivery of the software product such services are the only undelivered elements, paragraph 67 of this SOP requires that all revenue be recognized over the period during which the implementation services are expected to be provided.

Multiple-Element Arrangements—Products and Discounted PCS—Example 1

Facts

A software vendor has entered into an arrangement under which it has licensed software that has a list price of \$1 million to a customer for \$600,000 (which is the price being charged for the software when sold separately under other arrangements). The arrangement also includes annual PCS, priced for the first year at 15 percent of the discounted license fee, or \$90,000 (rather than 15 percent of the list price of the licensed software). After the first year, the customer will have the right to renew annual maintenance on the licensed software at 15 percent of the list price of the software (or \$150,000).

There are no other undelivered elements. All revenue recognition conditions of this SOP have been satisfied.

The vendor does not have sufficient vendor-specific historical evidence that costs of providing PCS are incurred on other than a straight-line basis.

Revenue Recognition

In Year 1, the total arrangement fee is \$690,000. Of this amount, \$552,000 should be allocated to the software element and recognized upon delivery of the software element. The remaining \$138,000 should be allocated to the PCS element and recognized ratably over the period during which the PCS services are expected to be performed. The allocation of the \$690,000 arrangement fee is determined as shown in the following table.

Fair value when sold separately:

Software element	\$600,000	80%
PCS element	<u>150,000</u>	<u>20%</u>
	\$750,000	100%

Allocation:

PCS element	$\$690,000 \times .20 = \$138,000$
Software element	$\$690,000 \times .80 = \$552,000$

Discussion

In allocating the arrangement fee to the PCS element, the vendor should look first to the price the customer will pay for the PCS when it is sold separately as a renewal under the arrangement. In this example, that price is \$150,000. This price is considered the vendor-specific objective evidence of the fair value for the PCS element, as discussed in paragraph 10.

If the customer were entitled to the PCS in subsequent years at the same price at which it had been included in the initial year of the arrangement (that is, \$90,000), and the vendor's pricing practices were such that renewals of PCS were based on the discounted value of license fees, no additional fees would have been allocated from the software element to the PCS element. Therefore, the vendor would have allocated \$600,000 to the software element and \$90,000 to the PCS element.

APPENDIX B

Response to Comments Received

- B.1** An exposure draft of a proposed Statement of Position (SOP), *Software Revenue Recognition*, was issued for public comment on June 14, 1996.
- B.2** The majority of the comments received related to the basic principles of the exposure draft, particularly the provisions requiring the allocation of the arrangement fee to individual elements in a multiple-element arrangement based on vendor-specific objective evidence of the fair value. Several commentators requested clarification of the wording in the exposure draft related to extended payment terms and the effect of such terms on the determination of whether a fee is fixed and determinable or collectible. Some commentators requested guidance on the application of the provisions of the SOP to marketing arrangements in which coupons or other price incentives are offered. Other commentators requested the reconsideration of the transition provisions of the exposure draft, which required a cumulative-effect adjustment.
- B.3** These comments and the Accounting Standards Executive Committee's (AcSEC's) response to them are discussed below.

Multiple-Element Arrangements

- B.4** Several commentators responded that the limitations on what constitutes vendor-specific objective evidence of the fair value were too onerous. These commentators stated that many instances exist in which elements are not priced separately, and that because of these limitations, revenue related to delivered elements would be deferred even though the customer received the element. Additionally, several commentators expressed concern that the requirement to allocate revenue to all elements, particularly those deliverable "when and if available," was not meaningful. (Obligations to deliver when and if available elements were considered by the commentators to be either insignificant vendor obligations or not vendor obligations at all.)
- B.5** AcSEC considered these comments but continues to support the provisions of the exposure draft. AcSEC noted that these com-

ments had been considered in the process leading to the exposure draft. Although AcSEC agrees that the provisions of the SOP may be troublesome to some companies, AcSEC notes that commentators did not suggest alternatives that AcSEC considered adequate to meet the criteria of objective evidence of fair value.

- B.6** AcSEC continues to believe that the allocation of the arrangement fee to all elements, including those deliverable on a when-and-if-available basis, is meaningful. AcSEC believes that these elements are bargained for by the customer and should be accounted for. Furthermore, AcSEC believes that the concept of significant versus insignificant obligations should not be used to determine whether revenue should be allocated to an element. This concept had been included in SOP 91-1 and had resulted in varying interpretations in practice. AcSEC further notes that these comments had been considered previously by AcSEC during the process leading to the exposure draft.
- B.7** Several commentators stated that the limitations on vendor-specific objective evidence of fair value should be expanded to permit the use of prices in published price lists. AcSEC believes that the price for an element as included in a price list does not necessarily represent the fair value of that element.

Extended Payment Terms

- B.8** The exposure draft stated that a software licensing fee should not be considered fixed or determinable if the payment of a significant portion of the licensing fee is not due until after the expiration of the license or more than twelve months after delivery. Exceptions were permitted for vendors that have a business practice of using installment contracts and an extended history of entering into contracts with terms in excess of twelve months and successfully enforcing payment terms without making concessions. Several commentators requested clarification of these provisions.
- B.9** AcSEC considered these comments and agreed that clarification was needed. Relevant clarifications were made to paragraphs 27 through 29 of the SOP. The revised provisions now state that *any* extended payment terms in a software licensing arrangement may indicate that the fee is not fixed or determinable, particularly if the use of extended payment terms is not the vendor's customary practice. Further, if the payment of a significant portion of the software licensing fee is not due until after the expiration of the license or more than twelve months after delivery, the licensing fee should be *presumed* not to be fixed or determinable. However, this presumption may be overcome by evi-

dence that the vendor has a standard business practice of using long-term or installment contracts and a history of successfully collecting under the original payment terms without making concessions. Such a vendor should consider such fees fixed or determinable and should recognize revenue upon the delivery of the software, provided all other conditions for revenue recognition in this SOP have been satisfied.

- B.10** Several commentators requested guidance on the application of the SOP to arrangements in which discounts are offered on subsequent licenses of software. The exposure draft did not have provisions addressing such arrangements.
- B.11** AcSEC has added wording to the scope section (paragraph 3) of the SOP to address these questions. The new wording states that arrangements in which a vendor offers a small discount on additional licenses of the licensed product or other products that exist at the time of the offer represent marketing and promotional activities that are not unique to software and, therefore, are not included in the scope of this SOP. However, judgment will be required to assess whether price-off and other concessions are so significant that, in substance, additional elements are being offered in the arrangement.

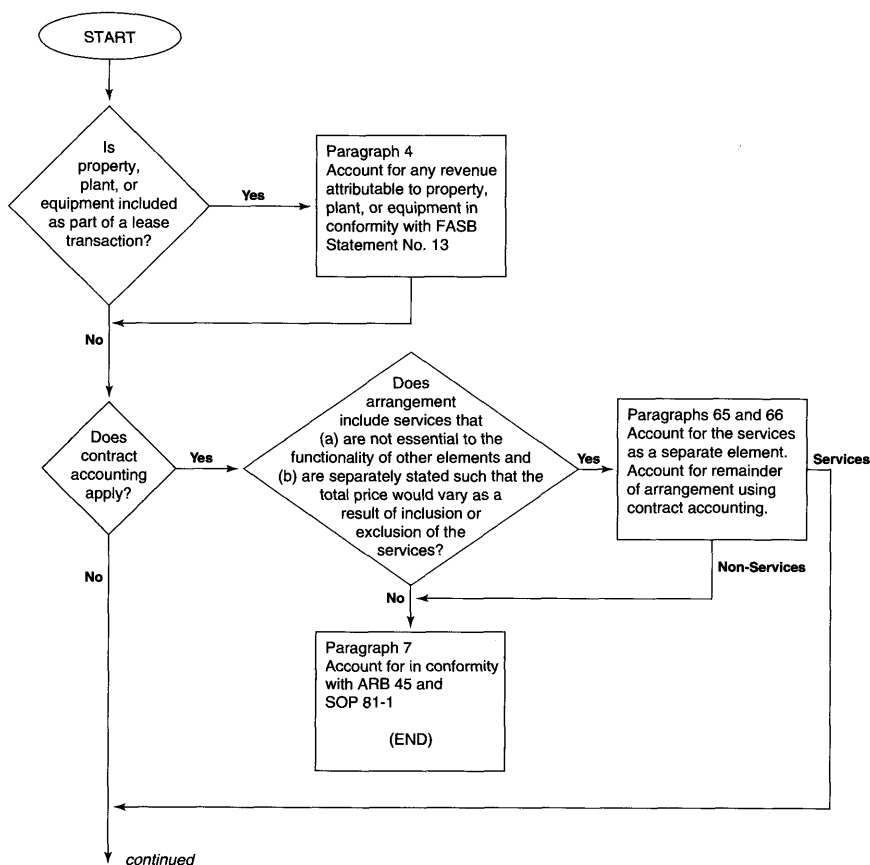
Transition

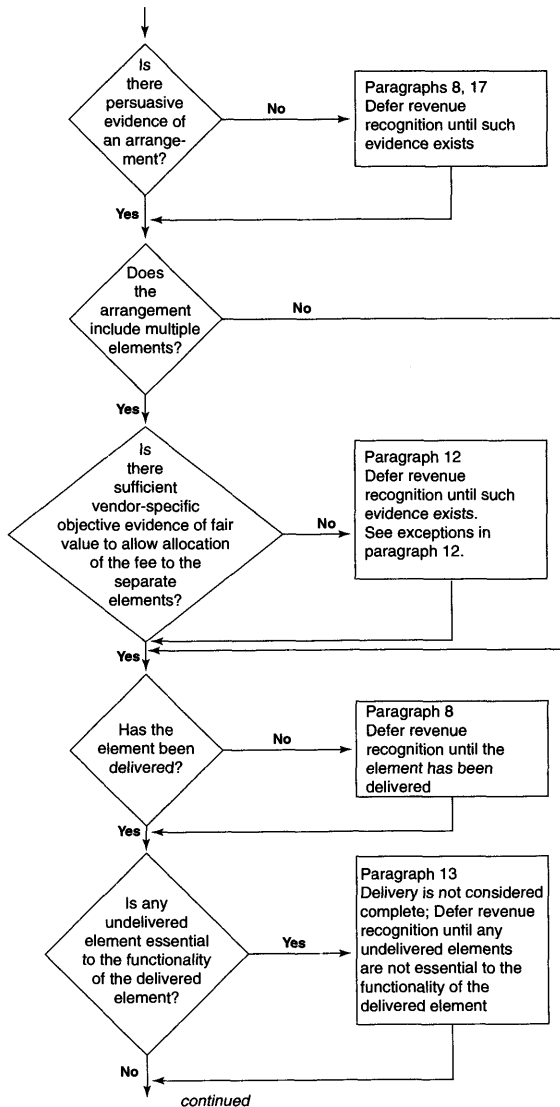
- B.12** The exposure draft required a cumulative-effect adjustment for the adoption of the SOP. Several commentators noted that considerable effort would be required on the part of many vendors to measure the cumulative effect. Additionally, it was noted that in many instances, the application of the provisions of this SOP to contracts existing in prior periods would require a significant amount of judgment. AcSEC was concerned that the application of that judgment likely would be influenced by the hindsight a company would have, resulting in judgments based on information that did not exist at the time of the initial judgment but that would be called for if the SOP were to be applied retroactively.
- B.13** AcSEC considered these issues and determined that the transition requirements of the SOP should be amended to require prospective application.

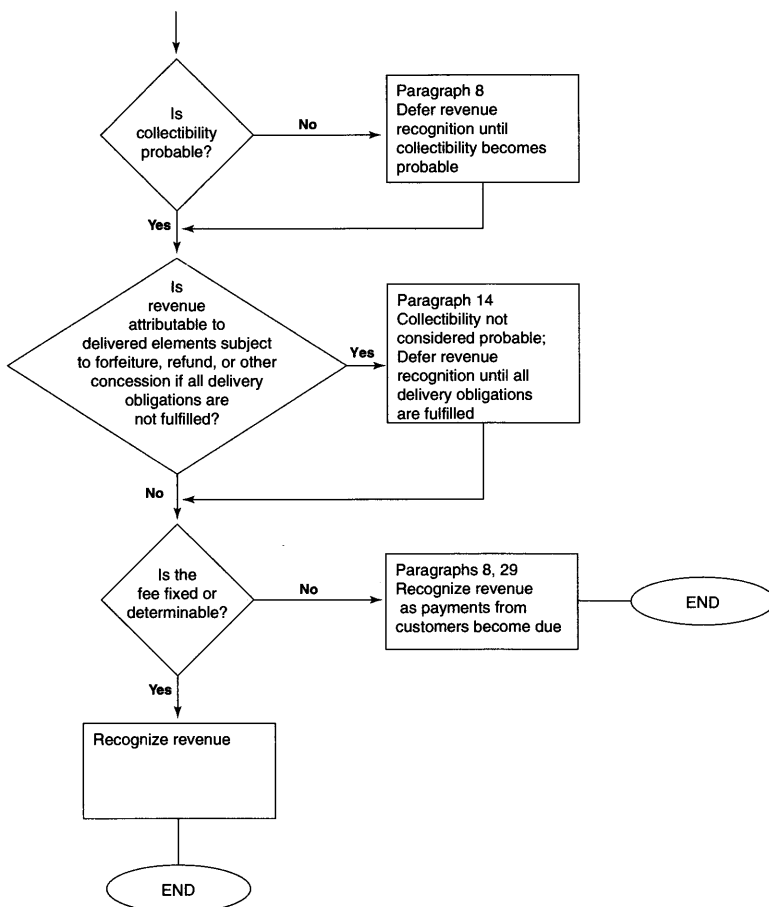
APPENDIX C

Revenue Recognition on Software Arrangements

The following flowchart illustrates a decision process for recognizing revenue on software arrangements. The flowchart is intended to illustrate the basic principle of revenue recognition and does not address the differences in accounting depending upon the type of element (services, upgrade rights, additional software products, or postcontract customer support) included in the arrangement. The flowchart summarizes certain guidance in this SOP and is not intended as a substitute for the SOP.







GLOSSARY

Authorization Codes (keys). A vehicle used by vendors to permit customers access to, use of, or duplication of software that would otherwise be restricted.

Core software. An inventory of software that vendors use in creating other software. Core software is not delivered as is because customers cannot use it unless it is customized to meet system objectives or customer specifications.

Customer. A user or reseller.

Delivery. A transfer of software accompanied by documentation to the customer. The transfer may be by the following:

- a.** A physical transfer of tape, disk, integrated circuit, or other medium
- b.** Electronic transmission
- c.** Making available to the customer software that will not be physically transferred, such as through the facilities of a computer service bureau
- d.** Authorization for duplication of existing copies in the customer's possession

If a licensing agreement provides a customer with the right to multiple copies of a software product in exchange for a fixed fee, delivery means transfer of the product master, or the first copy if the product master is not to be transferred.

Fixed fee. A fee required to be paid at a set amount that is not subject to refund or adjustment. A fixed fee includes amounts designated as minimum royalties.

Licensing. Granting the right to use but not to own software through leases or licenses.

Milestone. A task associated with long-term contracts that, when completed, provides management with a reliable indicator of progress-to-completion on those contracts.

Off-the-shelf software. Software marketed as a stock item that customers can use with little or no customization.

Platform. The hardware architecture of a particular model or family of computers, the system software, such as the operating system, or both.

Platform-transfer right. A right granted by a vendor to transfer software from one hardware platform or operating system to one or more other hardware platforms or operating systems.

Postcontract customer support (PCS). The right to receive services (other than those separately accounted for as described in paragraphs 65 and 66 of this Statement of Position) or unspecified product upgrades/enhancements, or both, offered to users or resellers, after the software license period begins, or after another time as provided for by the PCS arrangement. Unspecified upgrades/enhancements are PCS only if they are offered on a when-and-if-available basis. PCS does not include the following:

- Installation or other services directly related to the initial license of the software
- Upgrade rights as defined in this Statement of Position
- Rights to additional software products

PCS may be included in the license fee or offered separately. PCS is generally referred to in the software industry as maintenance, a term that is defined, as follows, in paragraph 52 of FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*:

Activities undertaken after the product is available for general release to customers to correct errors or keep the product updated with current information. Those activities include routine changes and additions.

However, the term *maintenance* is not used in this Statement of Position for the following reasons.

1. It has taken on a broader meaning in the industry than the one described in FASB Statement No. 86.
2. It may be confused with hardware maintenance as it is used elsewhere in accounting literature.
3. Its meaning varies from company to company.

The right to receive services and unspecified upgrades/enhancements provided under PCS is generally described by the PCS arrangement. Typical arrangements include services, such as telephone support and correction of errors (bug fixing or debugging), and unspecified product upgrades/enhancements developed by the vendor during the period in which the PCS is provided. PCS arrangements include patterns of pro-

viding services or unspecified upgrades/enhancements to users or resellers, although the arrangements may not be evidenced by a written contract signed by the vendor and the customer.

Reseller. Entity licensed by a software vendor to market the vendor's software to users or other resellers. Licensing agreements with resellers typically include arrangements to sublicense, reproduce, or distribute software. Resellers may be distributors of software, hardware, or turnkey systems, or they may be other entities that include software with the products or services they sell.

Site license. A license that permits a customer to use either specified or unlimited numbers of copies of a software product either throughout a company or at a specified location.

Upgrade/Enhancement. An improvement to an existing product that is intended to extend the life or improve significantly the marketability of the original product through added functionality, enhanced performance, or both. The terms upgrade and enhancement are used interchangeably to describe improvements to software products; however, in different segments of the software industry, those terms may connote different levels of packaging or improvements. This definition does not include platform-transfer rights.

Upgrade right. The right to receive one or more specific upgrades/enhancements that are to be sold separately. The upgrade right may be evidenced by a specific agreement, commitment, or the vendor's established practice.

User. Party that ultimately uses the software in an application.

When-and-if-available. An arrangement whereby a vendor agrees to deliver software only when or if it becomes deliverable while the arrangement is in effect. When-and-if-available is an industry term that is commonly used to describe a broad range of contractual commitments. The use of the term when-and-if-available within an arrangement should not lead to a presumption that an obligation does not exist.

**Accounting Standards Executive Committee
(1996–1997)**

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The Accounting Standards Executive Committee and the Software Revenue Recognition Working Group gratefully acknowledge the contributions of the former Software Revenue Recognition Task Force members Joseph Lhotka, Naomi Erickson, James Gillespie, Francis O'Brien, and Paul Wilde in the development of this Statement of Position.

